# DOCKET

No. 86-958-CFX
Status: GRANTED

Title: Norwest Bank Worthington, et al., Petitioners
v.
James R. Ahlers, et ux.

Docketed:
December 9, 1986

Court: United States Court of Appeals
for the Eighth Circuit

Counsel for petitioner: Conn Jr.,Gordon B., Moore,Clay R.

Counsel for respondent: Needler,William L.

| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 1 | Dec 9 1986 | G | Petition for writ of certiorari filed. |
| 3 | Dec 30 1986 | | Order extending time to file response to petition until January 23, 1987. |
| 4 | Jan 7 1987 | | Brief amicus curiae of ND Bankers Association filed. |
| 5 | Jan 8 1987 | | Brief amici curiae of Arkansas, et al. filed. |
| 6 | Jan 9 1987 | | Brief amicus curiae of First Bank System, Inc. filed. |
| 7 | Jan 12 1987 | | Brief amicus curiae of Minnesota Bankers Assn. filed. |
| 8 | Jan 21 1987 | | Brief amicus curiae of American Council of Life Insurance filed. |
| 9 | Jan 21 1987 | | Brief amicus curiae of Nebraska Bankers Assn. filed. |
| 10 | Jan 23 1987 | | Brief of respondents James R. Ahlers, et ux. in opposition filed. |
| 11 | Jan 23 1987 | G | Motion of respondents for leave to proceed in forma pauperis filed. |
| 12 | Jan 23 1987 | | Brief amicus curiae of Savings League of MN filed. |
| 13 | Jan 23 1987 | G | Motion of American Bankers Association for leave to file a brief as amicus curiae filed. |
| 14 | Jan 23 1987 | | Brief amicus curiae of American College of Real Estate Lawyers filed. |
| 15 | Jan 28 1987 | | DISTRIBUTED. February 20, 1987 |
| 16 | Feb 6 1987 | X | Reply brief of petitioners Norwest Bank, et al. filed. |
| 17 | Feb 23 1987 | P | The Solicitor General is invited to file a brief in this case expressing the views of the United States. |
| 18 | May 13 1987 | | Brief amicus curiae of United States filed. |
| 19 | May 19 1987 | | REDISTRIBUTED. June 4, 1987 |
| 20 | Jun 2 1987 | X | Supplemental brief of petitioners Norwest Bank, et al. filed. |
| 22 | Jun 8 1987 | | REDISTRIBUTED. June 11, 1987 |
| 24 | Jun 15 1987 | | REDISTRIBUTED. June 18, 1987 |
| 26 | Jun 22 1987 | | Motion of American Bankers Association for leave to file a brief as amicus curiae GRANTED. |
| 27 | Jun 22 1987 | | Motion of respondents for leave to proceed in forma pauperis GRANTED. |
| 28 | Jun 22 1987 | | Petition GRANTED. limited to Question 1 presented by the petition. |
| | | | ********** |
| 29 | Jul 23 1987 | G | Motion of respondents for leave to proceed further herein in forma pauperis filed. |
| 31 | Jul 31 1987 | | Order extending time to file brief of petitioner on the merits until August 21, 1987. |
| 32 | Aug 6 1987 | | Brief amicus curiae of United States filed. |
| 34 | Aug 6 1987 | | Brief amicus curiae of American Bankers Assn. filed. |

No. 86-958-CFX

| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 33 | Aug 7 1987 | | Brief amicus curiae of Nebraska Bankers Assn. filed. |
| 35 | Aug 12 1987 | | DISTRIBUTED. Sept. 28, 1987. (Motion of respondents for leave to proceed further herein in forma pauperis). |
| 36 | Aug 17 1987 | | Record filed. |
| 37 | Aug 20 1987 | | Brief amicus curiae of American Council of Life Insurance filed. |
| 38 | Aug 21 1987 | | Brief of petitioners Norwest Bank, et al. filed. |
| 39 | Aug 21 1987 | | Brief amicus curiae of American College of Real Estate Lawyers filed. |
| 40 | Sep 1 1987 | D | Motion of the Solicitor General for leave to participat in oral argument as amicus curiae and for divided argument filed. |
| 41 | Sep 8 1987 | G | Motion of petitioners to dispense with printing the joint appendix filed. |
| 42 | Sep 15 1987 | | Opposition of respondents to motion of the Solicitor General for leave to participate in oral filed. |
| 43 | Sep 21 1987 | | Brief amici curiae of Arkansas, et al. filed. |
| 47 | Sep 28 1987 | | Brief of respondents James R. Ahlers, et ux. filed. |
| 44 | Oct 5 1987 | | Motion of respondents for leave to proceed further herein in forma pauperis GRANTED. |
| 45 | Oct 5 1987 | | Motion of petitioners to dispense with printing the joint appendix GRANTED. |
| 46 | Oct 5 1987 | | Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument DENIED. |
| 48 | Nov 20 1987 | | CIRCULATED. |
| 49 | Nov 23 1987 | | SET FOR ARGUMENT. Tuesday, January 12, 1988. (2nd case). |
| 50 | Jan 7 1988 | D | Motion of petitioners for leave to file a reply brief, out-of-time filed. |
| 51 | Jan 11 1988 | | Motion of petitioners for leave to file a reply brief, out-of-time DENIED. |
| 52 | Jan 12 1988 | | ARGUED. |

# PETITION FOR WRIT OF CERTIORARI

86-938

Supreme Court, U.S.
FILED
DEC 9 1986
JOSEPH F. SPANIOL, JR.
CLERK

No._____

IN THE

# Supreme Court of the United States

October Term, 1986

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NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

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## JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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## QUESTIONS PRESENTED

1. Do the absolute priority provisions of Section 1129 of the Bankruptcy Code (11 U.S.C. § 1129) and this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), prohibit confirmation of a debtor's proposed reorganization plan where (i) the senior interests of unsecured creditors will not be paid in full; (ii) the debtor will retain ownership of property; and (iii) the debtor's only contribution to the plan of reorganization is its non-cash promise to provide future labor, experience and expertise?

The Court of Appeals held "No," reversing the district court and the bankruptcy court.

2. May a bankruptcy debtor use the automatic stay of 11 U.S.C. § 362(a) to retain possession and use of real estate and other collateral subject to a creditor's lien without providing any protection under 11 U.S.C. § 362(d) against decline in the value of the creditor's interest in the property until after expiration of state notice and redemption periods applicable to foreclosure or replevin?

The Court of Appeals held "Yes," reversing the district court and the bankruptcy court.

3. Does 28 U.S.C. § 46(c) require denial of *en banc* rehearing of a two-to-one panel decision where four judges vote to deny rehearing, five judges vote to grant rehearing, and the remaining judge is disqualified and does not vote?

The Court of Appeals denied rehearing on a five-to-four vote in favor of rehearing.

[NOTE: In the event that certiorari is granted as to the above questions, Petitioners reserve the right to argue the following question 4, but do not include Question 4 among the reasons for the grant of certiorari.]

4. Does a Court of Appeals abuse its discretion in overturning fact findings of the bankruptcy court and the district court

regarding lack of adequate protection and unfeasibility of reorganization on the basis of judicial notice of factual matters not presented to the courts below and on the basis of a legal proposition neither presented to the lower courts nor argued in the parties' briefs on appeal?



## LIST OF PARTIES

The parties to the proceedings below were Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul, and Respondents James R. Ahlers and Mary M. Ahlers. In addition, the United States Trustee participated in the proceedings with respect to matters not involved in this Petition.

Petitioner Norwest Bank Worthington is a subsidiary of Norwest Corporation. Pursuant to Rule 28.1, there is included in the Appendix a listing of Norwest Corporation and its corporate affiliates.

Petitioner Federal Land Bank of St. Paul is a federal instrumentality chartered by the Farm Credit Administration under 12 U.S.C. § 2011. It is a part of Farm Credit System established pursuant to the Farm Credit Act, 12 U.S.C. § 2001 *et seq*. Pursuant to Rule 28.1, there is included in the Appendix a statement describing Farm Credit System and its primary affiliates.

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I. The Court below violated established legal principles of absolute priority under 11 U.S.C. §1129(b)(2)(B) and the decision of this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), by holding that a bankruptcy debtor, by a mere promise of future labor, experience and expertise, may retain ownership of the reorganized enterprise without paying dissenting creditors in full. . . . . 8

II. The decision below that a debtor in bankruptcy may avoid lifting of the automatic stay without providing any payment or adequate protection to secured creditors until such time as the creditors otherwise could have obtained their collateral and sold it free and clear of any rights of redemption is contrary to the Bankruptcy Code's requirements for adequate protection, conflicts with views of other circuits, and violates the rights of secured creditors in bankruptcy. . . . . 12

III. The decision below denying rehearing *en banc* of a divided panel decision where five circuit judges voted in favor of rehearing, four voted against, and one was disqualified, conflicts with decisions of other circuits and will result in a rule of law of important general concern that does not reflect the views of a majority or plurality of the Court of Appeals. . . . . 17





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# No._____

IN THE

## Supreme Court of the United States

October Term, 1986

Norwest Bank Worthington and
Federal Land Bank of St. Paul,

Petitioners,

v.

James R. Ahlers and
Mary M. Ahlers,

Respondents.

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in the above proceeding on July 2, 1986, together with the orders of said court denying the petition for rehearing en banc and the motion for clarification of voting thereon.

## OPINIONS BELOW

The July 2, 1986, opinion of the Court of Appeals for the Eighth Circuit is reported at 794 F.2d 388 and is reprinted in the Appendix hereto (A. p. 1).

The September 17, 1986, Order of the Court of Appeals denying Petition for Rehearing En Banc has been reported at 794 F.2d 414 and is reprinted in the Appendix hereto (A. p. 51). The October 16, 1986, Order of the Court of Appeals on Motion for Clarification of Order Denying Petition for Rehear-

ing En Banc has not been reported and is reprinted in the Appendix hereto (A. p. 57).

The October 22, 1985, Order of the United States District Court for the District of Minnesota (Alsop, C.J.) has not been reported and is reprinted in the Appendix hereto (A. p. 79).

The March 15, 1985, Order of the United States Bankruptcy Court, District of Minnesota (O'Brien, J.), has not been reported and is reprinted in the Appendix hereto (A. p. 59).

## JURISDICTION

Federal jurisdiction over bankruptcy proceedings below under Title 11, United States Code, arises under 28 U.S.C. § 1334 and § 157. On Respondents' appeals from orders of the United States District Court for the District of Minnesota, affirming the bankruptcy court's order granting Petitioners' motion for relief from the automatic stay of 11 U.S.C. § 362, by order of July 2, 1986, the Court of Appeals reversed the lower courts and remanded for further proceedings. On September 17, 1986, a petition for rehearing was denied under 28 U.S.C. § 46(c) for lack of an affirmative vote of an absolute majority of the circuit judges in regular active service, and, on motion for clarification, it appeared that the one judge not voting had recused himself from participation.

The jurisdiction of this Court to review the judgment of the Court of Appeals is invoked under 28 U.S.C. § 1254(1).

## STATUTES INVOLVED

This case involves consideration of the absolute priority provisions under Section 1129 of the Bankruptcy Code, 11 U.S.C. § 1129, as well as application of the automatic stay and adequate protection provisions of the Bankruptcy Code, 11 U.S.C. § § 361, 362. The denial of rehearing *en banc* by the Court of Appeals with five judges voting in favor of rehearing, four voting against and the remaining judge disqualified also raises questions under 28 U.S.C. § 46(c) and Rule 16, Eighth Circuit Rules of Appellate Procedure. Pursuant to Rule 21.1(f), Supreme Court Rules, the text of these provisions is set forth in the appendix hereto (A. p. 91).



## STATEMENT OF THE CASE

The absolute priority rule in bankruptcy mandates that a debtor may not retain property in a reorganization without first satisfying the prior claims of creditors. In this Chapter 11 reorganization case, a divided panel of the Court of Appeals held that a debtor may retain ownership in a reorganized enterprise by contributing his promise of labor and experience instead of capital in a reorganization plan that does not fully repay creditors with superior interests. The decision is thus in stark opposition to the language of the Bankruptcy Code, the law of other circuit courts, and a long-standing holding of the Supreme Court. In addition, the panel held that a bankruptcy debtor may use the automatic stay of 11 U.S.C. §362(a) to retain possession and use of real estate and other collateral subject to a creditor's lien without protecting the creditor from decline in the value of its interest in the property. This holding shifts the entire risk of collateral devaluation from debtors to creditors.

In response to the motion to rehear, five of the nine judges participating recognized the far-reaching implications of the panel decision and voted to rehear the case. In the dissenting opinion, Judge Gibson stated that "the court has altered the relationship between debtor and creditor, invading serious policy issues properly the concern of Congress, and in doing so has substituted its own findings of fact for those made by the bankruptcy and district courts" (A. p. 54). The dissent concluded:

> Certainly, in some future case, there may be sufficient votes to enable this court to revisit the issue. This case, however, can now be resolved only in the Supreme Court. We are left to hope that, upon proper petition, it will grant certiorari."

(A. p 55). The background of this sweeping revision of bankruptcy law and sharp division of the Court of Appeals is summarized in the following discussion.

Respondents James and Mary Ahlers are grain and livestock farmers who farm approximately 840 acres of land in Nobles County, Minnesota. They borrowed money from Peti-

tioner Federal Land Bank of St. Paul ("Federal Land Bank") secured by first mortgages on four separate parcels of real estate. The aggregate principal amount these loans was $525,854 as of November 30, 1984.

Respondents also borrowed money from Petitioner Norwest Bank Worthington ("Norwest"). To secure these loans, Respondents gave Norwest a second mortgage on the real estate and a security interest in machinery, equipment, crops, livestock and other collateral. As of November 30, 1984, Respondents owed Norwest $450,468 in principal and accrued interest.

Respondents failed to pay their loan obligations. Shortly after Norwest sued to repossess its collateral, Respondents filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, thereby staying the state court replevin proceedings by reason of 11 U.S.C. § 362(a). Norwest and Federal Land Bank each filed motions for relief from the automatic stay.

After an evidentiary hearing, the bankruptcy court concluded (A. p. 61-67) that Federal Land Bank was substantially undersecured as to certain of the real estate, and that it was entitled to relief from the automatic stay unless Respondents could provide adequate protection of Federal Land Bank's interest in the property. It also concluded that Norwest had become undersecured and that Norwest was entitled to relief from the automatic stay unless Respondents could provide adequate protection of Norwest's interests in its collateral.

The bankruptcy court found that adequate protection would require payments equal to interest at 12 percent on the values of Norwest and Federal Land Bank's collateral. The court also held that Respondents' offers to to Petitioners did not constitute adequate protection. Since the Respondents were unable to make the payments required for adequate protection, the bankruptcy court granted the motions to lift the automatic stay, thereby permitting the creditors to proceed against their collateral.

Respondents' post-hearing motions and motions for stay pending appeal were denied by the bankruptcy court and district court. By order of August 8, 1985 (A. p. 75), the Court



of Appeals stayed enforcement of the lower court orders. In doing so, the Court of Appeals also requested that the district court determine the merits of the matter, including the feasibility of Respondents' reorganization in bankruptcy.

The district court (Alsop, C.J.) affirmed the bankruptcy court orders (A. p. 79), and reviewed the feasibility of reorganization. Applying the factors set forth in *United Properties, Inc. v. Emporium Department Stores, Inc.*, 379 F.2d 55, 66-71 (8th Cir. 1967), the district court found that:

> Analysis of debtors' proposed plan in light of these considerations reveals the plan's utter unfeasibility. The court presumes the debtors are capable farmers and managers, despite their present difficulties. All their other circumstances, however, mitigate strongly against success.

(Order, October 22, 1985, A. p. 86).

In reaching that decision, the district court found that the Respondents had a negative asset to liability ratio, were insolvent by a large margin, and further observed:

> Debtors also have failed to establish their ability to operate profitably in the future. Indeed, debtors have suffered large losses in recent years. Tr. 139. Debtors have no significant cash flow. Tr. 144. Finally, the oppressive economic conditions confronting American farmers are unlikely to improve soon, and any political assistance will be too little and too late to redeem circumstances as dire as debtors'. Therefore, debtors stand little chance of reorganizing successfully, even without regard to the monthly adequate protection payments required under Section 361.

(*Id.*, A. p. 87).

On appeal to the Eighth Circuit, the parties addressed issues which had been presented to the lower courts. Significantly, at no time did Respondents challenge the applicability of the absolute priority rule of 11 U.S.C. 1129(b), nor did Respondents suggest that the absolute priority rule could be

overcome by a debtor's promise of future labor, experience, and expertise.

The appeals were argued before a three-judge panel on January 13, 1986. By its July 2, 1986 decision (the "Panel Decision") (A. p. 1), a divided panel reversed Chief Judge Alsop's decision affirming the bankruptcy court's orders and finding that the Respondents' plan of reorganization was not feasible. The majority opinion was written by Judge Heaney, and was joined by Judge Wollman. Judge Gibson entered a dissenting opinion.

The majority opinion concluded that the automatic stay should not have been lifted and that the lower courts' determinations on feasibility were in error. These conclusions were reached by the following reasoning:

1. Respondents had no obligation to provide adequate protection to preserve the automatic stay until such time as Federal Land Bank and Norwest, under state law, would otherwise have been able to seize their collateral, sell the property, and reinvest the proceeds. In the case of real estate, the panel thus held that the obligation to provide adequate protection would not begin for one year and six weeks (A.p. 12).

2. In determining the value of the creditors' interests to be protected once the obligation to provide adequate protection comes into being, the court must determine the value of the interest in collateral as of the time the obligation arises; that is, the value to be protected in real estate is the value existing after expiration of the notice and redemption periods (A. p. 13).

3. Once the obligation to provide adequate protection does arise, no actual payments need be made until the debtor's cyclical business has cash available; *e.g.*, after crops or livestock have been sold (A. p. 14).

4. Norwest and Federal Land Bank were not entitled to relief from the stay on the basis of the absolute priority rule. Although the issue had not been raised or briefed, the court determined that the plan would be feasible and confirmable over the objections of impaired unsecured creditors and the



debtors would be able to retain their business without payment in full to the dissenting class of creditors because the debtors' future services, management, and expertise in operating their farm would be the equivalent of a capital contribution, thus avoiding the absolute priority rule (A. pp. 2-3, 24-25).

5. Finally, to demonstrate how a reorganization might in fact be accomplished under the announced criteria, the Panel Decision undertook a projected analysis of the debtors' operations based upon data outside the record, chiefly published values of land, equipment, and production costs, and reported commodities prices (A. pp. 37-49).

The dissenting opinion disagreed with the majority opinion for its conclusion that the obligation to provide adequate protection would not arise for a year and six weeks, and criticized the majority for taking judicial notice of "reasonable and established marketing techniques" and for failing to observe the clearly erroneous standard for review of the lower courts' findings as to adequate protection and feasibility of reorganization (A. pp. 28-36). The dissent also criticized the majority's holding that a debtor's "experience, knowledge, and labor" is the equivalent of capital sufficient to avoid the rule of absolute priority in bankruptcy, viewing the holding as unsupported by *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).Petitioners sought rehearing, with a suggestion for rehearing *en banc*. Various *amicus curiae* briefs were submitted in support of and in opposition to rehearing; a brief supporting rehearing was filed by the United States of America, respecting creditors' interests of various federal agencies. The Minnesota Bankers' Association, and North Dakota Bankers' Association also supported rehearing.

On September 17, 1986, on a vote of five in favor of rehearing, four opposing rehearing, and one not voting, the Court of Appeals denied rehearing (A. p. 51). Even though a majority of the judges voting favored rehearing *en banc*, rehearing was denied under 28 U.S.C. § 46(c) because an absolute majority (i.e., six) of the ten circuit judges had not voted to grant rehearing. The five judges favoring rehearing

filed dissenting opinions, and a dissenting opinion of four judges invited certiorari (A. pp. 54-55).

Federal Land Bank filed a motion for clarification of the voting procedure in light of *Arnold v. Eastern Airlines, Inc.*, 712 F.2d 899 (4th Cir.), *cert. denied*, 464 U.S. 1040 (1983), in which the Fourth Circuit Court of Appeals had held that a five-to-four vote with one judge disqualified was sufficient to order rehearing. The Court of Appeals denied the request to vacate the order denying rehearing, and although the order did not address the *Arnold* question, it did indicate that Judge Frank J. Magill had recused himself because he had represented Federal Land Bank prior to his appointment to the federal bench. The Court of Appeals did grant a stay of mandate until December 8, 1986, "to permit any party to this appeal to file a petition for certiorari with the United States Supreme Court" (A. p. 58).

## REASONS FOR GRANTING THE WRIT

### I

### THE COURT BELOW VIOLATED ESTABLISHED LEGAL PRINCIPLES OF ABSOLUTE PRIORITY UNDER 11 U.S.C. §1129(b)(2)(B) AND THE DECISION OF THIS COURT IN *CASE V. LOS ANGELES LUMBER PRODUCTS CO.*, 308 U.S. 106 (1939), BY HOLDING THAT A BANKRUPTCY DEBTOR, BY A MERE PROMISE OF FUTURE LABOR, EXPERIENCE AND EXPERTISE, MAY RETAIN OWNERSHIP OF THE REORGANIZED ENTERPRISE WITHOUT PAYING DISSENTING CREDITORS IN FULL.

The decision below is contrary to this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), is contrary to the express language and legislative history of 11 U.S.C. § 1129(b)(2)(B)(ii), and is contrary to decisions in other Circuits. The decision below is applicable in *every* Chapter 11 bankruptcy case and would permit shareholders, partners or sole proprietors to leave creditors unpaid at the end of a reorganization plan while retaining the benefits of ownership. It is important that this Court grant certiorari to



resolve a fundamental issue of federal bankruptcy law and to restore uniformity among the Circuits in applying the absolute priority rule.

Although the bankruptcy court had terminated the automatic stay of 11 U.S.C. § 362(a) on the grounds of lack of adequate protection of Petitioners' interests in their collateral, *see* 11 U.S.C. § 362(d)(1), the Court of Appeals instructed the district court to determine whether the Respondents' plan of reorganization was feasible (A. p. 77). The district court, after review of the record and applicable legal factors, found that the plan demonstrated "utter unfeasibility" (A. p. 86).

The Court of Appeals rejected the lower courts' findings of fact and determined that a plan could be proposed which was feasible (A. pp. 15-18). Because Norwest and Federal Land Bank would control the class of unsecured creditors by reason of the size of their unsecured claims, the Respondents would be able to confirm a plan over such creditors' opposition only through use of the "cram down" provisions of 11 U.S.C. § 1129(b). But that section provides that a plan may be confirmed over the objections of unpaid creditors only if the plan does not discriminate unfairly and the debtor does not retain *"any property."* 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).

Despite the absolute priority provision of the Bankruptcy Code, the Court of Appeals held that Respondents feasibly could confirm a plan which would permit them to retain property and participate in the plan based on their promise to devote their "experience, knowledge and labor" (A. pp. 3, 24-26). The Supreme Court has never permitted a debtor to retain ownership and control of its assets where dissenting creditors would not be paid in full and the debtor's only contribution to the reorganized enterprise was the debtor's promise of his future labor and efforts.

In *Los Angeles Lumber*, the district court had permitted confirmation of a plan of reorganization where creditors would have fared better under the plan than under a foreclosure. The debtor argued, among other things, that "continuity of management" and the shareholders' "financial standing and influence in the community" were of value sufficient to

permit the owners to participate in the plan even if creditors were not paid in full. This Court, however, reversed the district court, and stated that such items are

> illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests, would serve as easy evasions of the principle of full or absolute priority . . . . On the facts of this case they cannot possibly be translated into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the assets column of the balance sheet of the new company. They reflect merely vague hopes or possibilities.

308 U.S. at 122-23.

*Los Angeles Lumber* recognized that where a debtor injects fresh capital or its equivalent, the debtor might be able to participate in the plan to the extent of that contribution, but unanimously held that to permit shareholders to retain the benefits of ownership of an enterprise without a contribution of "money or money's worth" would violate the absolute priority rule, even where the management offered to use its skill to help the debtor survive. The fact that creditors might be better off under the debtor's proposal than under a liquidation was irrelevant to whether a plan could be confirmed.

The decision below is in direct conflict with *Los Angeles Lumber*, and is also contrary to the words of the statute and the legislative history of the 1978 Bankruptcy Code. The express language of 11 U.S.C. § 1129(b)(2)(B)(ii) does not permit a bankruptcy debtor to retain property in a plan of reorganization as in this case. Moreover, the legislative history demonstrates that if a dissenting class of unsecured creditors is not to be paid in full, then the debtors cannot retain *any* property under the plan.

In 1970, Congress established the Commission on Bankruptcy Laws to consider a new bankruptcy code. The Bankruptcy Commission proposed relaxation of the absolute priority rule to permit continued participation by owners or shareholders, even if unsecured creditors were not paid in full, by allowing the owners or shareholders to participate if they



"will make a contribution which is important to the operation of the reorganized debtor. . . ." Report of Commission on Bankruptcy Laws of the United States, H. R. Doc. 137, 93d Cong., 1st Sess. 242 (1973). The intent of the proposal, as submitted to Congress, was to allow "participation by ownership not permissible under the absolute priority test, if the participation is supported by e.g., continued management. . . ." *Id.* at 254.

After extensive comment on the proposals, Congress rejected the Commission's approach, and adopted the absolute priority rule of Section 1129(b)(2)(B) without any exception to permit owners to contribute and share in the plan if a dissenting class of unsecured creditors were not paid in full. The House Report on the new bill specifically provided:

> Simply put, the bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all.

H.R. Rep. No. 595, 95th Cong., 2d Sess. 224, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963, 6184. In light of the express words of the statute and Congress' clear rejection of efforts to dilute the absolute priority rule, the lower court's decision is in error, and must be reversed.

Finally, the lower court's decision is in conflict with a decision of the Sixth Circuit. In *Metropolitan Holding Co. v. Weadcock*, 113 F.2d 207 (6th Cir. 1940), the Court rejected the notion that a contribution of "money or money's worth" could be the same as a contribution of skill and experience in management and operation of the property:

> In such a case before a stockholder can retain his stock he must contribute the reasonable equivalent in money or money's worth of the participation accorded him but the stockholders propose to make no such contribution either in money, or, in view of the *Los Angeles* case, money's worth. The debtor and the trustee recognize the principle of the *Los Angeles* case but say that the provision whereby the debtor will remain in possession and enjoy the skill and experience of the stockholders in the management and operation of the property, is in effect a

> contribution by the stockholders, indirectly of course, of money's worth. But the obstacle to this contention is that it is in the face of the *Los Angeles* case.

113 F.2d at 209; *see also Spitzer v. Stichman*, 278 F.2d 402 (2d Cir. 1960) (creditors must be fully compensated before shareholders may participate, even on a contingent basis, without a fresh contribution in money or money's worth); *In re Muskegon Motor Specialties*, 366 F.2d 522 (6th Cir. 1966) (no room in the new corporation for the old shareholders unless they contribute fresh capital).

This Court should grant certiorari to ensure compliance with its decisions by the lower courts and to provide uniformity among the Circuits on this critical issue of federal bankruptcy law. The impact of the lower court's decision on Chapter 11 bankruptcies will be far-reaching and devastating for creditors. By promising future labor, service, and management at the outset of a plan, the shareholders, partners, or sole proprietors in *every* Chapter 11 case may leave unsecured creditors unpaid at the end of the plan and reap all future profits and benefits for themselves.

## II

### THE DECISION BELOW THAT A DEBTOR IN BANKRUPTCY MAY AVOID LIFTING OF THE AUTOMATIC STAY WITHOUT PROVIDING ANY PAYMENT OR ADEQUATE PROTECTION TO SECURED CREDITORS UNTIL SUCH TIME AS THE CREDITORS OTHERWISE COULD HAVE OBTAINED THEIR COLLATERAL AND SOLD IT FREE AND CLEAR OF ANY RIGHTS OF REDEMPTION IS CONTRARY TO THE BANKRUPTCY CODE'S REQUIREMENTS FOR ADEQUATE PROTECTION, CONFLICTS WITH VIEWS OF OTHER CIRCUITS, AND VIOLATES THE RIGHTS OF SECURED CREDITORS IN BANKRUPTCY.

In addition to rejecting uniform and long-standing interpretations of the absolute priority rule, the Decision also erodes



the rights of secured creditors by a sweeping revision of concepts of adequate protection under the bankruptcy laws. In doing so, the decision conflicts with virtually every Court of Appeals which has examined the fundamental principles of adequate protection under the 1978 Bankruptcy Code.

The concept of "adequate protection" of secured creditors' rights in collateral arises from two goals of the Bankruptcy Code: first, in order to promote reorganization, the Code allows a debtor the use of property subject to liens or security interests; and second, in order to ensure that such use does not cause harm to secured creditors, the Code protects the value of their interests in the collateral. A bankruptcy law which does not protect the property interests of secured creditors violates the Fifth Amendment to the United States Constitution. *See Louisville Joint Land Bank v. Radford*, 295 U.S. 555 (1935); *see also United States v. Security Industrial Bank*, 459 U.S. 70, 75 (1982)("The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation."). "Adequate protection" reflects the intent of Congress that there be no unconstitutional "taking" of the secured creditors' property. S. Rep. No. 989, 95th Cong., 2d Sess. 49, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 5835. Thus, the Bankruptcy Code requires that a debtor must provide "adequate protection" to a secured creditor as a condition for using the secured creditor's "cash collateral" during the bankruptcy case, 11 U.S.C. § 363(e), and also must provide adequate protection to retain the use of property subject to a lien.

The Bankruptcy Code describes by example, but does not limit, how such adequate protection is to be provided. *See* 11 U.S.C. § 361. Prior to the decision below, no court had challenged the premise that Section 361 requires adequate protection "to the extent that the stay . . . results in a decrease in the value of [the creditor's] interest in such property." 11 U.S.C. § 361(1). Extensive controversy has occurred, however, over the provision of Section 361(3) allowing for adequate protection to be provided by granting the creditor the "indubitable equivalent" of the creditor's interest in the

property.[1] Some courts have held that 11 U.S.C. § 361(3) requires that a secured creditor be compensated for its "lost opportunity cost" of delay in the sale of collateral. *See, e.g., In re American Mariner Industries, Inc.*, 734 F.2d 426 (9th Cir. 1984); *Grundy National Bank v. Tandem Mining Corp.*, 754 F.2d 1436 (4th Cir. 1985). Other courts have rejected that approach, holding that "lost opportunity cost" is post-petition interest which 11 U.S.C. § 506 prohibits for undersecured creditors. *See, e.g., In re Timbers of Inwood Forest*, 793 F.2d 1380 (5th Cir. 1986).[2]

Prior to the decision below, the Eighth Circuit had taken a middle ground, holding that an undersecured creditor is not entitled to lost opportunity payments as a matter of law, but that such payments may be provided by the bankruptcy court based upon the facts of a particular case. *In re Briggs Transportation Co.*, 780 F.2d 1339, 1349 (8th Cir. 1985). All courts considering these questions had recognized the paramount requirement to protect the value of the creditor's interest in the collateral against depreciation, liens, taxes, waste, and the like. For example, in *Grundy*, adequate protection required payment to cover depreciation over the useful life of the equipment involved, 754 F.2d at 1438, and the payment of interest as "lost opportunity costs" was possible *in addition to* such payments to preserve the value of the collateral. A similar approach was taken in *Mariner*, 734 F.2d at 428, and in *Briggs*, 780 F.2d at 1341.

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1. *See, e.g.*, Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in* Bankruptcy, 51 U. Chi. L. Rev. *97 (1984)*; Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 Minn. L. Rev. 1 (1983); Jackson, *Bankruptcy, Non- Bankruptcy Entitlements, and the Creditor's Bargain*, 91 Yale L. J. 857 (1982); Note, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. Chi. L. Rev. 305 (1983); Comment, *Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause*, 52 U. Chi. L. Rev. 795 (1985).
2. *In re Timbers of Inwood Forest*, 793 F.2d 1380 (5th Cir. 1986), a unanimous panel decision, was entered July 9, 1986. Counsel understand that the opinion was withdrawn July 9, 1986. The matter was argued in rehearing *en banc* September 22, 1986, and the decision on rehearing is pending.



The legislative history of Sections 361 and 362 of the 1978 Bankruptcy Code clearly demonstrates that the key element of the concept of adequate protection was to protect secured creditors against impairment of their interests in collateral through depreciation, use, and the like. *See* S. Rep. No. 989, 95th Cong., 2d Sess. 54, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 5840; *Timbers of Inwood Forest*, 739 F.2d at 1393-1401; Note, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. Chi. L. Rev. 795 (1985). Whether the "indubitable equivalent" language of Section 361(3) requires provision of lost opportunity compensation as part of the secured creditor's benefit of the bargain with the debtor is the question involved in the split among the circuits in *Mariner*, *Grundy*, *Briggs*, and *Timbers of Inwood Forest*.[3] The *Ahlers* decision satisfies neither aspect of adequate protection.

The fundamental flaw in the holding of the panel majority on adequate protection is twofold: First, by focusing on the benefit-of-the-bargain approach of *American Mariner*, the Court lost sight of the fact that the "lost opportunity cost" analysis relates to protection *in addition to* the fundamental need to protect the interest in the collateral itself; second, even under the benefit-of-the-bargain analysis applicable to protection of lost opportunity costs, the *Ahlers* decision does not "protect" the bargain but rather drastically *impairs* it in situations involving real estate.

By holding that a secured creditor is entitled to no adequate protection of its collateral until such time as it actually could have obtained physical possession and realized the proceeds of sale, the decision below would provide no protection against diminution in value of the collateral during that period. In the case of real estate that unprotected period would include statutory notice and redemption periods, a year and six weeks

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3. Although an analysis of the legislative history of the 1978 Bankruptcy Code may lead to differing conclusions as to whether provision for lost opportunity costs was contemplated, it is of interest to note that the legislative history of the recent enactment of Chapter 12 to the Bankruptcy Code does imply that the *Mariner* analysis may be correct. *See* H. R. Rep No. 958, 99th Cong., 2d Sess. 49 (1986) (Conference Report).

in Minnesota. During that time, the risk of loss from a decline in land values is totally on the *creditor*. *See Ahlers*, 794 F.2d at 398-99 n.13; *id* at 404 (Gibson, J., dissenting). (A. p. 28). Moreover, in the case of a junior mortgagee such as Norwest, its interest in the collateral will suffer even further erosion, as real estate tax liens accrue against the property and interest accrues on the oversecured senior mortgagee's position. The value of the junior mortgagee's interest in the collateral is thus demonstrably impaired, with no adequate protection.

In fact, the panel majority's approach would be devastating upon all real estate lenders because it would *double* the time before they could realize upon and reinvest their collateral. If mortgagees are not entitled to relief from the automatic stay until one year and six weeks after they move for such relief, and if after that time the debtor is unable to provide adequate protection and the stay is lifted, the state law notice and redemption periods would only then start to run. The result would be that the lenders could not realize upon and reinvest the value of their collateral for *another* year and six weeks. During the entire two years and twelve weeks the secured creditors' interests will have been at risk of erosion of value, but the debtor will have had full use and possession of the property, and all rents and profits, while providing *no* protection to secured creditors.

Even if restricted to the lost opportunity analysis, the decision below is fatally flawed. It concluded that since a debtor could not realize proceeds from resale for a year and six weeks, no protection need be provided until that time has elapsed. That reasoning assumes that a secured creditor would not resell the property until expiration of the period of redemption (A. p. 12). But a foreclosing mortgagee does have an ownership interest in property upon a foreclosure sale, albeit subject to the possibility of redemption, and that interest in property could immediately be sold and the proceeds reinvested. By delaying commencement of the period of redemption, the value of that property right is diminished, both by reason of decline in the underlying collateral value and by reason of the delay in commencing the running of the redemption period. Any purchaser of the creditor's interest would discount the price to reflect that delay, and the value of



the creditor's interest is diminished accordingly. Under the decision below that impairment of value is unprotected.

The erosion of heretofore unquestioned concepts of adequate protection will seriously put at risk the rights of secured real estate lenders in every Chapter 11 proceeding. By making the commencement of the right to adequate protection dependent upon the vagaries of state laws respecting notice, redemption, defenses to foreclosure, and the like, the decision below will promote protracted litigation and appeals, and jeopardize property rights of secured creditors. This Court should grant certiorari and reverse.

## III

## THE DECISION BELOW DENYING REHEARING EN BANC OF A DIVIDED PANEL DECISION WHERE FIVE CIRCUIT JUDGES VOTED IN FAVOR OF REHEARING, FOUR VOTED AGAINST, AND ONE WAS DISQUALIFIED, CONFLICTS WITH A DECISION OF THE FOURTH CIRCUIT AND WILL RESULT IN A RULE OF LAW OF GENERAL CONCERN THAT DOES NOT REFLECT THE VIEWS OF A MAJORITY OR PLURALTY OF THE COURT OF APPEALS.

In denying the Petitioners' motion for a rehearing and suggestions for rehearing *en banc*, the Court of Appeals did so in the face of five judges voting in favor of rehearing, and four (including the two-person majority of the Panel Decision) voting against. The tenth member of the Court of Appeals disqualified himself because of prior representation of Federal Land Bank, and did not vote on the petition for rehearing. Apparently viewing 28 U.S.C. § 46(c) as requiring a majority vote of the entire court, including disqualified judges, the Court of Appeals concluded that the five-to four plurality in favor or rehearing was not sufficient to order rehearing *en banc*. This view conflicts with *Arnold v. Eastern Air Lines, Inc.*, 712 F.2d 899 (4th Cir.), *cert. denied*, 464 U.S. 1040 (1983), which held under similar circumstances that a disqualified judge is not considered in determining the majority required under the statute. As a consequence of the denial of

rehearing, a divided panel decision on important rules of law will become the law of the Eighth Circuit, despite the fact that four judges have strongly disagreed with its legal analysis and a fifth has indicated tentative agreement with the dissenting majority. (A. pp. 53-54).

Despite the possible majority support of the views of the dissent to the Panel Decision, the rule of the Panel Decision will become and remain for some considerable time the law in the Eighth Circuit unless modified by this Court. The anomaly of having the legal views of between two and four circuit judges become the law of the circuit when opposing views are held by five of the circuit judges will result both from circuit precedent and from practical considerations.

The precedent is that the panel decision will be binding upon all succeeding three-judge panels in the Eighth Circuit; it can be overturned only by the court *en banc*. *See United States v. Howard*, 706 F.2d 267, 269 (8th Cir. 1983). The practical consideration is that the issue may not come before the court *en banc* for years, particularly if a voting majority of judges not disqualified cannot order rehearing *en banc*.

In most situations, this Court might reasonably conclude to allow the Court of Appeals majority to overrule this minority decision in due course, on a case-by-case basis. Bankruptcy, however, presents unique considerations. Because the intent of the Bankruptcy Code is to promote prompt adjudication of cases to achieve either reorganization or liquidation, creditors affected by the decision below will be under substantial practical pressures either to accede to the debtor's position or to negotiate a somewhat better treatment under a plan; because a secured creditor now will have no adequate protection during most of the pendency of the case, for a creditor to pursue appellate remedies in the hope of ultimately overturning *Ahlers* will require that creditor to risk even greater erosion of its collateral position while appeal is pending. The result is that, so long as *Ahlers* remains the law in the Eighth Circuit, creditors in every Chapter 11 case will suffer risk of loss which will never be compensated.

This anomalous situation of having a clear minority of a Court of Appeals establish a novel but controlling rule of law is not required by statute, and in the present circumstances



may be contrary to statute. This Court has recognized that, as a matter of internal administration, a Court of Appeals is "free to devise its own administrative machinery to provide the means whereby a majority may order such a hearing," *Western Pacific Railroad Corp. v. Western Pacific Railroad Co.*, 345 U.S. 247, 250 (1953). Where a Court of Appeals by rule or generally promulgated practice requires that non-voting judges be considered in determining whether there is an affirmative majority, that practice will not be disturbed by this Court. *Shenker v. Baltimore & Ohio Railroad Co.*, 374 U.S. 1, 4-5 (1963).

*Shenker*, however, did not involve the question of disqualification for purposes of the statute, but rather only treatment of non-voting judges. In *Arnold*, the Fourth Circuit had no such rule or generally promulgated practice as had the Third Circuit in *Shenker*, and, in addition, *Arnold* involved the question of disqualification. The *Arnold* court based its analysis solely upon its reading of the statute. In the present case, although the Eighth Circuit does provide by rule procedures for voting on *en banc* questions, that rule does not specify that disqualified judges are to be deemed part of the group of which a majority must vote for an *en banc* hearing. Rule 16(a), Eighth Circuit Rules of Appellate Procedure. Instead, the Eighth Circuit rule paraphrases the statute, thereby suggesting that the *Arnold* analysis is applicable. Thus, the basis for this Court's deference in *Schenker* is not present here. Rather, the issue here turns on the proper interpretation of a controlling federal statute.

As recognized in *Western Pacific*, the *en banc* power of Courts of Appeals is necessary and useful and should not be ignored in cases where its use might be appropriate. 345 U.S. at 260. In the present case, where a clear plurality—and maybe a majority—of the Court of Appeals disagrees with the Panel Decision and where the consequences of the Panel Decision will have such substantial impact upon bankruptcy cases and the rights of creditors throughout the Eighth Circuit, to deny rehearing based upon the fortuity of disqualification is contrary to the purpose of the *en banc* power and to efficient judicial administration.

This Court has previously undertaken to correct errors in voting on *en banc* determinations, *Moody v. Albemarle Paper Co.*, 417 U.S. 622 (1974), and Petitioners respectfully submit that it was error for the Court of Appeals to deny rehearing in the face of a five-to-four vote in favor of rehearing, where the tenth judge was not simply absent or not voting, but was disqualified from participating.

## CONCLUSION

In an effort to address perceived crises in the farm economy, the court below has made bad law. Disregarding both *Los Angeles Lumber* and Congress' refusal to modify the absolute priority rule in enacting the 1978 Bankruptcy Code, the court below has wrought a sweeping change in concepts of absolute priority in bankruptcy. In reaching for a result, it has also radically altered concepts of adequate protection of secured creditors, taking an approach at odds both with the Bankruptcy Code and with every Court of Appeals which has considered issues of adequate protection.

The Court of Appeals has made these changes by using a device, Chapter 11 of the Bankruptcy Code, which is designed for business debtors generally, not for the particular circumstances of farmers. In attempting to make the wrong tool repair the perceived problem, it has damaged the tool itself, tothe serious detriment of both secured and unsecured creditors. By denial of rehearing, it made the views of a minority the law of the circuit, over the dissent of a plurality of the court.



The issues presented are serious and grave for all creditors in Chapter 11 bankruptcy cases, and Petitioners respectfuliy request that their petition for certiorari be granted.

Dated: December 8, 1986

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IN THE

# Supreme Court of the United States

October Term, 1986

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NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

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## APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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# United States Court of Appeals
## FOR THE EIGHTH CIRCUIT

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No. 85-5396

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In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

James R. Ahlers and
Mary M. Ahlers,
Appellants,

v.

Norwest Bank Worthington
and Federal Land Bank,
Appellees.

Appeals from the United States District Court for the District of Minnesota.

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No. 85-5397

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In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

Norwest Bank
Worthington, N.A.,
Appellee,

v.

James R. Ahlers and
Mary M. Ahlers,
Appellants.

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Submitted: January 13, 1986
Filed: July 2, 1986

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Before HEANEY, JOHN R. GIBSON and WOLLMAN, Circuit Judges.

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BEST AVAILABLE COPY



HEANEY, Circuit Judge.

These appeals by James and Mary Ahlers raise important questions of bankruptcy law, particularly as that law relates to farmers who have filed petitions for reorganization under Chapter 11 of the Bankruptcy Code. We hold that the bankruptcy court may, as a condition to maintaining a stay of proceedings by creditors against the debtors' property, require that the debtors furnish adequate protection to the secured creditors to protect against further loss to those creditors. Adequate protection is to be determined on a case-by-case basis by the bankruptcy court in accordance with the following guidelines: (1) protection is ordinarily to be given for the interim period beginning with the date that the secured creditor could, under state law, obtain possession of the collateral, sell that property, and reinvest the proceeds, and ending with the date that the plan of reorganization is confirmed or dismissed; (2) the value of the property is to be determined as of the date that adequate protection payments are required; (3) crops in the ground, to the extent that they are not otherwise encumbered, may serve in whole or in part as a basis for adequate protection; and (4) payment for such protection may be made after the crop is harvested rather than on a monthly basis.

The bankruptcy court should not approve a plan of reorganization unless it is feasible. In determining feasibility, the court should recognize existing realities, that is, the values of the land, the equipment, and the inventory as of the date that the plan is confirmed. Thus, the secured debt should be restructured to reflect values as of the date of confirmation. The bankruptcy court should not approve the plan unless it appears reasonably probable that the farmer can pay the restructured secured debt, over a reasonable period of time, at a reasonable rate of interest, in the light of farm prices and farm programs as of the date of confirmation.

To insure that the plan is fair and equitable and protects the unsecured creditors, the plan should require that any cash flow from the operation of the farm in excess of that anticipated in the plan be paid to the unsecured creditors on a pro rata basis, until such time as the unsecured creditors are paid



in full without interest. Moreover, the plan should require that if the land is sold during the pendency of the plan, and if the unsecured creditors have not been paid in full before that date, any proceeds exceeding those necessary to pay the secured debt be shared on an equitable basis between the debtor and the unsecured creditors. Finally, the court should not permit the prejudgment seizure of equipment and machinery necessary to carry out the plan even if the creditors offer to post a bond.

We recognize that, under a plan of reorganization, secured creditors become unsecured to the extent that their allowed claim exceeds the value of their interest in the collateral. We hold, however, that neither these nor other unsecured creditors can prevent the plan from being approved on the basis of the absolute priority rule if the plan meets the requirements outlined herein and if the debtor agrees to contribute his experience, knowledge, and labor to the successful implementation of the plan.

## I. BACKGROUND.

James and Mary Ahlers farm approximately 840 acres of land in Nobles County, Minnesota. They own 560 acres, and rent the remaining 280 acres. To finance their operation, they entered into four separate financing agreements with the Federal Land Bank between December, 1965, and January, 1982. To secure these loans, the Ahlers gave the Federal Land Bank a first mortgage on four separate parcels of their farmland. These parcels of land, and the principal balances of the loans they secured as of November 30, 1984, are as follows:

| Parcels | Principal Balance |
|---|---|
| Parcel A (240 acres) | $ 335,403 |
| Parcel B (160 acres) | $ 152,168 |
| Parcel C (80 acres) | $ 31,500 |
| Parcel D (80 acres) | $ 6,783 |

The Federal Land Bank's security interests are not cross-collateralized.

The Ahlers also entered into several financing agreements with the Norwest Bank of Worthington, Minnesota ("Norwest") between May, 1982, and April, 1984. To secure these loans, the Ahlers gave Norwest a second mortgage on their farmland, and a first mortgage on their machinery and equipment, crops, livestock, and other farm proceeds. As of November 30, 1984, the Ahlers owed Norwest $450,468 in principal and accrued interest. Norwest's security interests are all cross-collateralized. The Ahlers also owe John Deere Credit Corporation $35,791, secured by a combine, the Commodity Credit Corporation $3,337, secured by a grain bin, and General Motors $2,900, secured by an automobile. The value of land in southwest Minnesota[1] and the value of used farm machinery have both declined markedly since the Ahlers entered into the financing agreements outlined above. Moreover, commodity prices have declined, and inclement weather has frequently played havoc with yields. Thus, the Ahlers have been unable to make payments on interest and principal, and the secured creditors are substantially undersecured.

On November 16, 1984, Norwest commenced a replevin action against the Ahlers in state court to recover possession of the Ahlers' equipment and machinery pursuant to Minn. Stat. Ann. § 565.23 (West Cum. Supp. 1985). Fourteen days later, the Ahlers filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*,

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1. According to the highly respected publication of the University of Minnesota, Dion and Raup, *The Minnesota Rural Real Estate Market in 1985*, Minnesota Agricultural Economist, No. 650, Jan. 1986, average land values in southwest Minnesota increased from $844 per acre in 1975 to $2,083 per acre in 1981. They fell to $1,401 per acre in 1984, and to $967 per acre in 1985. This study supports the testimony of the Federal Land Bank's expert witness, Dennis Christensen, that land values in southwest Minnesota continued to fall in 1984. With respect to the propriety of using these studies for the limited purpose intended in this opinion, *see* Davis, *Judicial Notice*, 55 Col. L. Rev. 945, 951 (1955); Wright & Graham, Federal Practice & Procedure: Evidence § 5102, p. 462; Currie, *Appellate Courts Use of Facts Outside of the Record by Resort to Judicial Notice and Independent Investigation*, 1960 Wisc. L. Rev. 39. *See also Brown v. Board of Education*, 347 U.S. 483 (1954); *AFL v. American Sash & Door Co.*, 335 U.S. 538, 551 (1949); *Jay Burns Baking Co. v. Bryan*, 264 U.S. 504 (1924).



thereby staying the state court replevin proceedings. *See* 11 U.S.C. § 362(a). Norwest and the Federal Land Bank filed motions for relief from the automatic stay and for adequate protection. On February 27, 1985, the bankruptcy court held an evidentiary hearing on these motions.

In an order issued March 15, 1985, the bankruptcy court stated that Norwest and the Federal Land Bank, as undersecured creditors, were

> entitled to compensation as adequate protection for the delay of enforcing contractual repossession and foreclosure rights during the interim between the filing of the petition and confirmation of the plan. It is the present value of that interest, the opportunity lost, that must be protected.

*In re Ahlers*, No. 3-84-2206, slip op. at 5 (Bankr. Minn. March 15, 1985).

It then held that the Ahlers would be required to make monthly payments of interest on the current value of the collateral in order to maintain the section 362 stay. It decided that the Ahlers' offer of a lien on the following year's crops did not constitute adequate protection, and that the Ahlers did not otherwise have sufficient funds to provide Norwest and the Federal Land Bank with adequate protection in the form of monthly interest payments on the value of the collateral. For these reasons, it granted the motions for relief from the automatic stay.[2] The Ahlers appealed this order to the district court. It affirmed on October 22, 1985. In addition, pursuant to this Court's August 8, 1985, order, the district court

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2. The bankruptcy court also concluded that a $12,200 retainer paid by the Ahlers' son to their attorney was excessive and deprived the Ahlers of funds needed to pay for living expenses during the pendency of the case. It ordered the Ahlers' attorney to return the retainer fee to the son and, in a subsequent order, awarded the attorney $5,000 for fees and expenses incurred, without prejudice to the attorney's application for additional expenses incurred at a later date. We find no abuse of discretion and affirm. *See* S. Rep. No. 989, 95th Cong., 1st Sess. 39-40, *reprinted in* 1978 U. S. Code Cong. & Ad. News 5787, 5825-26; *In re McCombs*, 751 F.2d 286, 288 (8th Cir. 1984); *In re Mullendore*, 527 F.2d 1031, 1038 (10th Cir. 1975).

reviewed the feasibility of the Ahlers' reorganization plan and found that the plan had no reasonable prospect of success.

Eleven days after the bankruptcy court had entered its March 15, 1985, order granting Norwest's and the Federal Land Bank's motions for relief from the section 362 stay, the Ahlers removed Norwest's replevin action from state court to the bankruptcy court. The bankruptcy court, concerned that the state replevin action was not a core proceeding, indicated that it might abstain and remand the replevin action to the state district court unless the parties consented to the bankruptcy court's jurisdiction over the matter. On May 24, 1985, the Ahlers and Norwest stipulated that the replevin action was a core proceeding, which could be heard and determined by the bankruptcy court. *See* 28 U.S.C. § 157(c)(2). Thereafter, Norwest filed a motion in the bankruptcy court for prejudgment seizure of the property, together with an offer of bond, pursuant to Minn. Stat. Ann. §§ 565.23 and 565.25 (West Cum. Supp. 1985). On June 25, 1985, the bankruptcy court held a hearing on Norwest's motion, and on July 8, 1985, entered an order granting this motion. The Ahlers appealed this order, and on October 28, 1985, the district court affirmed.

The Ahlers now appeal from the district court's October 22 and October 28 order. They contend that the bankruptcy court erred in granting Norwest and the Federal Land Bank relief from the section 362 stay. They also appeal the October 28 order, contending that the Minnesota replevin statute is unconstitutional, and that the bankruptcy court did not have jurisdiction to rule on Norwest's motion for prejudgment seizure pursuant to that statute.

## II. DISCUSSION.

### A. The district court erred in defining the elements of adequate protection.

The filing of a Chapter 11 bankruptcy petition results in an automatic stay of all acts by creditors to enforce their liens against the debtor's property. 11 U.S.C. § 362(a). The purpose is twofold: first, to give the debtor a "breathing spell" from his



creditors;[3] and second, to prevent one creditor from rushing to enforce its lien to the detriment of the other creditors.[4] The impact of the automatic stay is tempered by certain creditor safeguards, one of which is the secured creditor's right to adequate protection of its interest during the bankruptcy proceedings. 11 U.S.C. § 362(d).

Although adequate protection is not specifically defined in the Bankruptcy Code, Congress intended that a debtor's offer of adequate protection should, as nearly as possible under the circumstances of the case, provide the creditor with its bargained-for rights. *In re Briggs Transportation Co.*, 780 F.2d 1339 (8th Cir. 1985); *In re Martin*, 761 F.2d 472, 476 (8th Cir. 1985); *see also* H. R. Rep. No. 595, 95th Cong., 1st Sess. 339, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963, 6295 ("the purpose of [adequate protection] is to ensure that the secured creditor receives in value essentially what he bargained for"). However, Congress expressly did not state how these bargained for rights were to be valued, nor when this valuation was to occur.

> The section does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development. It is expected that the courts will apply the

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3. *See* H. R. Rep. No. 595, 95th Cong., 1st Sess. 340, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963, 6296-97.
> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.
> *Id.*

4. *See* H. R. Rep. No. 595 at 340, 1978 U.S. Code Cong. & Ad. News at 6297.
> The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.

concept in light of facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result. * * * The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.

H. R. Rep. No. 595 at 339, 1978 U.S. Code Cong. & Ad. News at 6295.

Thus, while it is agreed that a secured creditor should receive adequate protection of its interest during an automatic stay, any adequate protection determination must necessarily turn on the unique facts presented in each individual case. *See, e.g., In re Briggs,* 780 F.2d at 1348. These factual findings are subject to the clearly erroneous standard of review, *In re Martin,* 761 F.2d at 474; Bankr R. 7052(a), and to this Court's right to correct errors of law. *Martin,* 761 F.2d at 475 (quoting *Bose Corp. v. Consumer Union of United States, Inc.,* 466 U.S. 485, 501 (1884)).[5]

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5. "Allowed secured claim" is defined at 11 U.S.C. Section 506(a). If the creditor has a lien against property, and if he is oversecured, the allowed secured claim is the amount of the debt. If he is undersecured, it is the value of the collateral. Hence, the statute contemplates the division of claims into secured and unsecured parts, with reference to the worth of the property. As explained in the House Report: "One of the more significant changes from current law in proposed Title 11 is the treatment of secured creditors and secured claims. Unlike current law, H.R. 8200 distinguishes between secured and unsecured claims, rather than between secured and unsecured creditors. The distinction becomes important in the handling of creditors with a lien on property that is worth less than the amount of their claim, that is, those creditors that are undersecured. Current law is ambiguous and vague, especially under Chapter XIII, on whether an undersecured creditor is to be treated as a secured creditor, or as a partially secured and partially unsecured creditor. By addressing the problem in terms of claims, the bill makes clear that an undersecured creditor is to be treated as having a secured claim to the extent of the value of the collateral and an unsecured claim for the balance of his claim against the debtor. *** H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 180-81 (1977), *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 6141.



**1. The starting date for adequate-protection payments.**

The bankruptcy court held that the Federal Land Bank and Norwest were entitled to adequate protection payments in the form of interest on the value of the collateral securing their loans. This conclusion was based upon the premise that due to the automatic stay, the Federal Land Bank and Norwest were unable to immediately foreclose, liquidate the collateral, and reinvest the liquidation proceeds. *See In re American Mariner Industries, Inc.,* 734 F.2d 426 (9th Cir. 1984). It held that the Federal Land Bank was entitled to monthly adequate protection interest payments as of January 1, 1985 (date of the Ahlers' post-petition default on the Federal Land Bank loans), and that Norwest was entitled to monthly adequate protection interest payments as of February 27, 1985 (date of the evidentiary hearing). It found that the Ahlers did not have sufficient funds to make these monthly payments, and that a lien on the following year's crops could not constitute adequate protection. Accordingly, it granted the Federal Land Bank's and Norwest's motions for relief from the automatic stay.

A secured creditor is entitled to adequate protection of its security interest. T[illegible]t protection *may* include compensation to a creditor, in the form of post-petition interest payments, for the delay in enforcing the creditor's foreclosure rights. *In re Briggs,* No. 84-5196, slip op. at 23. Thus, we cannot say as a matter of law that the bankruptcy court erred in requiring post-petition interest payments. The question, then, is the timing and amount of these payments.

The concept of providing a secured creditor with adequate protection in the form of interest on the value of the collateral is premised on the theory that a secured creditor bargains for the right to take possession of the collateral and sell it in the event that the debtor defaults. *American Mariner,* 734 F.2d at 435 (this right constitutes an "interest in property" that is

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*In Re South Village, Inc.,* 25 Bankr. 987 (Bankr. D. Utah 1982) (quoting *In re Alyucan Interstate Corp.,* 12 Bankr. 803, 806-09 (Bankr. D. Utah 1981).

"created and defined by state law"). To the extent that a debtor can, by filing a bankruptcy petition, preclude or delay a secured creditor from exercising this right and reinvesting the liquidation proceeds, the creditor has been deprived of this benefit of its bargain. Thus, adequate protection payments in the form of interest are designed to insure that the secured creditor receives the benefit of its bargain by placing it in essentially the position it would have been in absent the filing of a bankruptcy petition. *See* H.R. Rep. No. 595 at 339, 1978 U.S. Code Cong. & Ad. News at 6295. Accordingly, in fashioning adequate protection payments, the bankruptcy court must determine the date when the creditor, absent the filing of a bankruptcy petition, could have taken possession of the collateral under state law and could have sold it to a third party, the amount that the creditor would have realized at this sale, and the creditor's expected return upon reinvestment.

Payments to protect the creditor's right to reinvestment return on foreclosure proceeds should not begin until, under state law, the creditor could have taken possession of the collateral, sold it to a third party, and reinvested the proceeds. *American Mariner*, 734 F.2d at 435 n.12 ("to avoid overcompensating the secured creditor, the timing of adequate protection should take account of the usual time and expense involved in repossession and sale of collateral."); *see also In re Bear Creek Ministorage, Inc.*, 49 Bankr. 454, 458-59 (Bankr. S.D. Tex. 1985); *In re South Village, Inc.*, 25 Bankr. 987, 996 n.14 (Bankr. Utah 1982).

Before the bankruptcy court considers the usual foreclosure delays associated with the particular collateral involved, it must first determine the date to which these delays will be added. If the secured creditor has commenced foreclosure proceedings prior to the filing of the bankruptcy petition, the starting date should be the date foreclosure proceedings were commenced. If, however, the secured creditor has not commenced foreclosure proceedings prior to the filing of the bankruptcy petition, the starting date should be the date that the creditor moves for adequate protection in the bankruptcy



court.[6] To the appropriate date, the bankruptcy court should add the usual foreclosure delays associated with the particular collateral involved.

With respect to the farmland, Minnesota law provides that six-weeks published notice must be given before a foreclosure sale. Minn. Stat. Ann. § 580.03 (West 1947). In addition, the mortgagor has the exclusive right to redeem the realty for twelve months following the foreclosure sale.[7] Minn. Stat. Ann. §§ 580.23, subd. 2, and 580.24 (West Cum. Supp. 1985). During this twelve-month redemption period, the mortgagor is entitled to possession, rents, and profits of the real estate. *Johnson v. First National Bank of Montevideo*, 719 F.2d 270, 276 (8th Cir. 1983), *cert. denied*, 104 S.Ct. 1015 (1984). Because the purchaser at a mortgage foreclosure sale would not be entitled to possession and profits from the real estate until after the redemption period had expired, it is extremely unlikely that a third party would purchase the property at the foreclosure sale. Moreover, Minnesota law prohibits the inclusion in a mortgage instrument of any provision under which rents and profits arising from the mortgaged property after default are assigned to the mortgagee. *Erickson-Hellekson-Vye Co. v. A. Wells Co.*, 217 Minn. 361, 15 N.W.2d 162 (1944).[8]

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6. *See Grundy National Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1441 (4th Cir. 1985). If the secured creditor has not initiated any action to gain possession and liquidate the collateral prior to the filing of the bankruptcy petition, it has not been deprived of this benefit of its bargain when the petition is filed. Thus, the starting date should not be when the petition is filed, but rather when the secured creditor seeks either possession of the collateral or adequate protection. Moreover, this ruling will prevent a hardship to the debtor caused by an adequate protection motion filed well after the bankruptcy petition has been filed, which could require sizeable "makeup" payments. It is not unreasonable to require the creditor to be vigilant in requesting protection if it wants this protection.
7. The twelve-month redemption period applies to tracts of land exceeding ten acres in size. Minn. Stat. Ann. § 580.23, subd. 2(c). For tracts of land less than ten acres in size, the redemption period is six months. *Id.* § 580.23, subd. 1.
8. *See also Orr v. Bennett*, 135 Minn. 443, 446, 161 N.W. 165 (1917), where the court stated:

Thus, assuming that Norwest and the Federal Land Bank follow reasonable and established marketing techniques, they will purchase the realty themselves at the foreclosure sale, and then attempt to resell the property after the redemption period has expired, if the Ahlers have not exercised their redemption rights. Since their right to foreclosure and to reinvest the liquidation proceeds would give them no financial benefit until the land could be resold to a third party, which at the earliest would be one year and six weeks from the date the foreclosure proceedings were commenced, the Ahlers' adequate protection payments to protect this right to reinvestment returns on foreclosure proceeds should not begin until that date. *See, e.g., Bear Creek Ministorage*, 49 Bankr. at 457-58. If no foreclosure proceedings were commenced before the filing of the bankruptcy proceeding, the adequate protection payments would begin one year and six weeks after the adequate-protection motion was filed by the creditor.

Under Minnesota law, Norwest would be permitted to take possession of the farm machinery and equipment promptly unless the debtor is dependent on the use of the property to earn a living. In that event, the debtor is permitted to retain the property for a period of time if he insures it and makes payments essentially similar to what he would be required to make under the Bankruptcy Act. Minn. Stat. Ann. § 565.251 (West Supp. 1986). It follows that adequate protection payments for farm machinery equipment should begin promptly on application therefor. Secured collateral such as livestock and grain in storage may be readily liquidated without any significant delay, and, hence, adequate protection payments on these items should also begin on application.

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[T]he mortgagor has the right of possession and the right to the rents and profits of the land incident to possession during the statutory year allowed for redemption and until the foreclosure is complete; and any stipulation in the mortgage, or contemporaneous with it, pledging the rents and profits of the mortgaged land to the payment of the mortgage debt contravenes the policy of that statute and is void.



**2. The date of valuation of collateral for adequate-protection purposes.**

Congress specifically left open the question of the date of valuation. *See* p. 10, *infra*. The bankruptcy court determined that values for purposes of adequate protection were to be fixed as of the date the petition was filed. While this decision is appropriate with respect to the livestock and grain in storage, which, under state law, could have been sold immediately, it is inappropriate with respect to the collateral that could not have been sold immediately. That collateral should be valued at the time it could have been sold under state law as discussed in section II.A.1 of this opinion. Even if this timing error were ignored, the bankruptcy court's findings as to the values of the land and equipment were clearly erroneous. In making his decision, it failed to take into account the fact that land values had declined by at least twenty-four percent in the twelve-month period immediately preceding the filing of the petition in bankruptcy.[9] There is likewise no support in the record for the bankruptcy court's statement that the debtor based his opinion as to value on conjecture.[10]

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9. Dennis Christensen was called as an expert for the Federal Land Bank. He testified in February of 1985 that farmland values in Nobles County declined by twenty-four percent in 1984. He further stated: "This investigation along with recent trips to southern and southwestern Minnesota lead me to believe the real estate market for farm properties is very soft and getting softer." Arden Harberts was called as an expert witness for Norwest. He testified that land values in the County fell by thirty percent from June, 1983, to June, 1984, and by an additional fifteen percent from the latter date to February, 1985. Christensen failed to provide detailed information as to when the comparable sales used by him took place except that they occurred during 1984. Harberts reported that he used four sales as comparables. Two occurred in September and two in November.

10. In response to a direct question from the court as to the basis of his opinion as to his land values, Ahlers stated: "Mostly hearsay. There is land around here that will bring in six and seven hundred dollars, too, and five hundred dollars and the like. I have heard in the last four or five or six months of prices being as high as a thousand dollars, but that was for land better than mine." Under Minnesota law, an owner is qualified to testify as to the value of his own land. *Vreeman v. Davis*, 348

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The bankruptcy court will redetermine these values on remand.

### 3. Timing of periodic-protection payments.

The bankruptcy court ruled that the Ahlers must make adequate-protection payments monthly to maintain the automatic stay. This ruling ignores the cyclical nature of agriculture. A grain farmer's income is not dependent upon a monthly paycheck, but rather upon the harvest of his crops at the end of the growing season. Likewise, a hog farmer's income is realized when the hogs are sold. Thus, adequate protection payments in the Ahlers' case should not be due until they have harvested their crops and sold their hogs.[11]

### 4. The use of growing crops as adequate protection.

We next address the bankruptcy court's ruling that the Ahlers' offer of a lien on the following year's crop could not constitute adequate protection. This issue was thoroughly addressed in *In re Martin*, 761 F.2d 472 (8th Cir. 1985), in which we held that a lien on a future crop, to the extent that the crop was otherwise not encumbered, may serve in whole or in part as a basis for providing adequate protection. We also outlined a non-exclusive list of factors the bankruptcy court should consider in making this determination. *Id.* at 477. Thus, the bankruptcy court's ruling was contrary to the law of this circuit.

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N.W.2d 756 (Minn. 1984); *LaValle v. Aqualand Pool Co., Inc.*, 257 N.W.2d 324 (Minn. 1977).

11. Of course this does not mean that adequate protection payments may not be accumulated prior to the harvest. For example, if the payments were to begin in May, and the crop was harvested in August, the farmer would be required to pay the four months' accumulated adequate protection payments in August. As discussed in the following section, a lien on this growing crop may provide the creditor with adequate protection during this period.



## B. The district court erred in holding that reorganization under Chapter 11 is unfeasible.

Norwest and the Federal Land Bank contend that even assuming their interests were adequately protected during the automatic stay, they were entitled to relief from the stay under 11 U.S.C. § 362(d)(2)(B) because the Ahlers' reorganization plan was not feasible. Section 362(d) provides:

> (d) On request of a party and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or
>
> (2) with respect to a stay of an act against property under subsection (a) of this section, if—
>
> (A) the debtor does not have an equity in such property; and
>
> (B) such property is not necessary to an effective reorganization.

11 U.S.C. § 362(d).

Several courts have interpreted the "necessary for an effective reorganization" language in section 362(d)(2)(B) to require a debtor to not only show that the property in question is essential to the reorganization plan, but also that an effective reorganization is realistically possible. *See, e.g., In re Albany Partners, Ltd.*, 749 F.2d 670, 673 n.7 (11th Cir. 1984); *In re Discount Wallpaper Center, Inc.*, 19 Bankr. 221, 222 (Bankr. M.D. Fla. 1982); *In re Dublin Properties*, 12 Bankr. 77, 80 (Bankr. E.D. Pa. 1981), and cases cited therein. As the court stated in *Dublin Properties*, "If no reorganization of the debtor is feasible, then no property of that debtor can be necessary for that end." 12 Bankr. at 80. We have no quarrel with these decisions.

The district court, pursuant to this Court's August 8, 1985, order, reviewed the feasibility of the Ahlers' reorganization

plan. It analyzed the plan on the basis of the factors outlined in *United Properties, Inc. v. Emporium Department Stores, Inc.*, 379 F.2d 55, 66-71 (8th Cir. 1967),[12] and found that the plan was utterly unfeasible because (1) the debtor's current liabilities exceeded his current assets by a substantial margin, and (2) the debtor could not, in the light of his past experience and current or anticipated farm programs, be expected to operate profitably with a significant cash flow.

Although the district court's feasibility determination is subject to the clearly erroneous standard of review, *id.* at 63-64, "an appellate court has the power to correct errors of law, including 'a finding of fact that is predicated on a misunderstanding of the governing rule of law.'" *Martin*, 761 F.2d at 475 (quoting *Bose Corp. v. Consumer Union of United States, Inc.*, 466 U.S. 485, 501 (1984).

The district court's feasibility finding was predicated on a misunderstanding of the applicable law in that the district court failed to determine the value of the collateral, and therefore the amount of the secured creditors' allowed secured claims, independent of the bankruptcy court's adequate protection valuation. For purposes of the reorganization plan, the value of the collateral is to be determined at the time for confirmation of that plan. An initial valuation for adequate protection purposes is not res judicata for purposes of determining the value of the collateral, and thus the allowed secured claims of the creditors, under a reorganization plan. *See* 11 U.S.C. § 506(a).

> While courts will have to determine value on a case-by-case basis [11 U.S.C. § 506(a)] makes it clear that valuation is to be determined in light of the purpose of the

12. Following are the factors that were outlined in *United Properties, Inc. v. Emporium Department Stores, Inc.*, 379 F.2d 55, 66-71 (8th Cir. 1967): (1) the ratio of current assets to current liabilities; (2) the debtor's solvency; (3) evidence that the debtor could operate at a profit; (4) the debtor's cash flow; (5) the capability of the debtor's management; and (6) economic conditions affecting the debtor's situation. Based on this analysis, the district court found that the proposed plan was utterly unfeasible, even without regard to the monthly adequate protection payments required by the bankruptcy court.



> valuation and the proposed disposition or use of the subject property. This determination shall be made in conjunction with any hearing on such disposition or use of property or on a plan affecting the creditor's interest. To illustrate, a valuation early in the case in a proceeding under sections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan. Throughout the bill, references to secured claims are only to the claim determined to be secured under this subsection, and not to the full amount of the creditor's claim.

S. Rep. No. 989 at 68, U.S. Code Cong. & Ad. News at 5854.

This revaluation is particularly important when, as in this case, the evidence demonstrates that the collateral decreased in value after the adequate protection valuation. Accordingly, because the district court failed to revalue the collateral in determining the feasibility of the Ahlers' reorganization plan, its feasibility finding was based on a misunderstanding of the applicable law. Under these circumstances, it is appropriate to remand the case so that findings may be made applying the correct legal standards, and we need not address the issue of whether the district court's feasibility finding was clearly erroneous. *Martin*, 761 F.2d at 475.[13]

We note, however, that our review of the record leads us to believe that the Ahlers may be able to propose a feasible reorganization plan. While the Ahlers' current liabilities do exceed their current assets, it appears probable that once their secured debt is restructured to reflect present values of

13. The dissent argues that this Court's opinion places the loss resulting from a drop in farmland values during the pendency of the automatic stay entirely on the banks, and that this result is neither reasonable nor fair. However, the banks will be protected from falling values from the date that they could obtain possession of the property until the plan is confirmed, *see* section IIA(1) of this opinion, and this period should ordinarily be more than sufficient to obtain confirmation or rejection of a plan. As for the loss that occurs during the redemption period, banks unfortunately will have to absorb this loss with or without a bankruptcy proceeding. Indeed, if a feasible plan is submitted and approved, the banks may realize more under reorganization than they could under liquidation. This opinion simply recognizes reality.

land and equipment as Section 506(a) requires, they can repay that debt over a reasonable period of time with interest and make substantial payments to unsecured creditors. (The banks will hold more than ninety-five percent of the unsecured debt.) The basis for this conclusion is set forth in Appendix A to this opinion.

In brief, the Ahlers, on the basis of the record before us and current farm prices and programs, can reasonably expect an annual income of $126,500 per year from their farming operations. This sum would be disbursed essentially as follows:

| | |
|---|---|
| to FLB as payments on secured debt on land of $306,000 (30 years at 12.5%) | $ 38,500 |
| to Norwest as payments on secured debt on land of $89,000 (30 years at 12.5)% | $ 11,500 |
| to Norwest, John Deere, and Commodity Credit Corporation as payments on secured debt on personal property of $94,000 (6 years at 10%) | $ 21,500 |
| to GMAC on secured debt of $3,000 (3 years at 10) | $ 1,200 |
| Ahlers' living expenses | $ 11,500 |
| tax and priority claims | $ 4,500 |
| unsecured claims (This sum would be increased to $29,500 per year after 6 years.) | $ 37,800 |
| | $126,500 |

Our conclusion is, of course, based on the record before this Court at this time, and is not intended to bind the bankruptcy court on remand. On remand, the debtors will be permitted to amend their proposed plan, within thirty days of the receipt of this opinion, to reflect the law as stated in this opinion. If an amended plan is presented, the bankruptcy court will hold hearings on the plan and confirm or reject it on the basis of



current data as to land and equipment values, interest rates, and farm prices and programs.

## C. The absolute priority rule does not prevent this reorganization.

Norwest and Federal Land Bank contend that they are entitled to relief from the automatic stay because any feasible reorganization plan submitted by the Ahlers could not be confirmed. They argue that because their claims are substantially undersecured, any reorganization plan would treat a portion of their claims as unsecured. 11 U.S.C. §506(a). As a class of unsecured creditors, they insist that they would not accept a reorganization plan, because the Ahlers could not pay the unsecured claims in full. Thus, they contend that the plan could not be confirmed under 11 U.S.C. § 1129(a)(8)(A).

Furthermore, Norwest and the Federal Land Bank argue that the Ahlers would not be successful in having the plan confirmed over their objections under 11 U.S.C. §1129(b). They insist that because the Ahlers could not pay their unsecured claims in full, and because the Ahlers would retain an interest in the farm under a reorganization plan, the plan would not satisfy the "fair and equitable" requirement of section 1129(b)(1). Because Norwest and the Federal Land Bank have, to this point, expressed their unwillingness to accept any plan under section 1129(a), we will examine whether a plan may be confirmed over their objections under section 1129(b).

Section 1129(b)(1) provides that a bankruptcy court shall, at the request of the debtor or other proponent, confirm a Chapter 11 plan over the objection of a class of creditors if the plan does not discriminate unfairly and is fair and equitable with respect to each class of creditors that has not accepted the plan. 11 U.S.C. § 1129(a)(1). Section 1129(b)(2) establishes the standards for determining whether a plan is "fair and equitable." It adopts three different tests to determine whether a plan is fair and equitable, depending on whether the dissenting class is comprised of secured claims, unsecured claims, or ownership interests. *See generally* 11 U.S.C. § 1129(b)(2)(A)-(C).

**1. Secured claims.**

With respect to a class of secured claims, a plan may provide

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b)(2)(A).

Under subparagraph (i) the plan may be confirmed if the secured creditors retain a lien securing the amount of their allowed secured claims[14] and they receive deferred cash payments having a present value, as of the effective date of the plan, equal to the present value of the collateral.[15]

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14. The allowed secured claim will equal the value of the collateral at the time the plan is confirmed. *See* 11 U.S.C. § 506(a); S. Rep. No. 989 at 68, 1978 U.S. Code Cong. & Ad. News at 5854.

15. *See* H.R. Rep. No. 595 at 414-15, 1978 U.S. Code Cong. & Ad. News at 6370-71.

Application of the test under [11 U.S.C. § 1129(b)(2)(A)] also requires a valuation of the consideration "as of the effective date of the plan." This contemplates a present value analysis that will discount value to be received in the future; of course, if the interest rate paid is equivalent to the discount rate used, the present value and face future value will be identical.



Alternatively, the plan may be confirmed under subparagraph (ii) if the plan proposes to sell the collateral free and clear of the secured parties' liens, as long as the lien will attach to the sale proceeds and will receive treatment under subparagraph (i) or (iii). Finally, subparagraph (iii) permits confirmation if the plan provides for the realization by the dissenting class of secured creditors of the indubitable equivalent of their claims. The legislative history to this subparagraph states that abandonment of the collateral to the secured creditor would clearly satisfy indubitable equivalence, as would a lien in similar collateral. 124 Cong. Rec. H32,407 (daily ed. Sept. 28, 1978) (statement by Rep. Don Edwards).

Assuming that the Ahlers' reorganization plan proposes that they remain on the farm and continue to use the secured collateral in their farming operation, the plan must, to be confirmed over the dissent of the secured creditors, propose that the secured creditors retain a lien in the collateral securing the amount of their allowed secured claims, and that they receive deferred cash payments having a present value equal to the value of the collateral securing their claims as of the effective date of the plan. 11 U.S.C. § 1129(b)(2)(A)(i). If the plan also proposes to pay the secured creditors a reasonable rate of interest on their allowed secured claims, the present value and face future value will be identical. *See* H.R. Rep. No. 595 at 414-15, 1978 U.S. Code Cong. & Ad. News at 6370-71.

**2. Unsecured claims.**

With respect to a class of dissenting unsecured creditors, a plan will be "fair and equitable" if one of two tests is satisfied. First, the plan may provide that each unsecured creditor in the class receive or retain property having a value, as of the

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Normally, the interest rate used in the plan will be prima facie evidence of the discount rate because the interest rate will reflect an arms length determination of the risk of the security involved and feasibility considerations will tend to understate interest payments.

*Id.*

effective date of the plan, equal to the allowed amount of its claim. 11 U.S.C. § 1129(b)(2)(B)(i). Norwest and the Federal Land Bank contend, and we agree, that any realistic reorganization plan proposed by the Ahlers could not provide the unsecured creditors with property equal to the amount of their allowed claims. Thus, any feasible plan would not meet the "fair and equitable" standard of section 1129(b)(2)(B)(i).

Alternatively, the plan may provide any treatment for the class of unsecured creditors, including no participation at all,[16] as long as no junior claims or interests participate in the plan or retain an interest in the debtor's property. 11 U.S.C. § 1129(b)(2)(B)(ii). Norwest and the Federal Land Bank contend that because the Ahlers could not provide the unsecured creditors with property equal to the allowed amount of their claims, any non-liquidation plan would not satisfy the "fair and equitable" standard of section § 1129(b)(2)(B)(ii). They argue that under any reorganization plan, the Ahlers would retain an equitable ownership interest, which is junior to the unsecured creditors' claims, without providing for the unsecured creditors in full. We do not agree that retention of this equitable ownership interest is fatal to the Ahlers' plan being "fair and equitable" under section § 1129(b)(2)(B)(ii).

Section 1129(b)(2)(B) essentially applies a modified version of the traditional absolute priority rule, which was initially established in *Northern Pacific Railway v. Boyd*, 228 U.S. 482 (1913). *See* 3 Norton, *Bankruptcy Law & Practice* § 63.21 (1985). Simply stated, the absolute priority rule provides that

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16. *See* 124 Cong. Rec. H32,408 (daily ed. Sept. 28, 1978) (statement by Rep. Don Edwards):

> Alternatively, under [11 U.S.C. § 1129(b)(2)(B)(ii)], the court must confirm the plan if the plan provides that holders of any claims or interests junior to the interests of the dissenting class of impaired unsecured claims will not receive any property under the plan on account of such junior claims or interests. As long as senior creditors have not been paid more than in full, and classes of equal claims are being treated so that the dissenting class of impaired unsecured claims is not being discriminated against unfairly, the plan may be confirmed if the impaired class of unsecured claims receives less than 100 cents on the dollar (or nothing at all) as long as no class junior to the dissenting class receives anything at all.

*Id.*



a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under the plan. However, in cases decided after *Boyd*, the Supreme Court specifically recognized that there may be circumstances in which the absolute priority rule could be modified to allow a junior ownership interest to participate in the reorganization plan even though dissenting senior creditors may receive less than their allowed claims.

In *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), the Court stated:

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court, as we have seen, indicated as much in *Northern Pacific Railway Co. v. Boyd, supra* [228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931] and *Kansas City Terminal Ry. Co. v. Central Union Trust Co., supra* [271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028]. Especially in the latter case did this Court stress the necessity, at times, of seeking new money "essential to the success of the undertaking" from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

*Id.* at 121 (footnote omitted).

The Court continued by stating that if these conditions were satisfied,

> the creditor cannot complain that he is not accorded "his full right of priority against the corporate assets."
>
> In view of these consideration we believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money *or in money's worth,* reasonably equivalent in view of all the circumstances to the participation of the stockholder.
>
> *Id.* at 122 (footnotes omitted) (emphasis added).

In the *Kansas City Terminal Railway* case cited by the Court in *Case*, the Supreme Court stated:

> Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.

*Kansas City Terminal Railway*, 271 U.S. at 455.

*See also Sophian v. Congress Realty Co.*, 98 F.2d 499, 502 (8th Cir. 1938) ("to justify retention of stock interests by stockholders of debtor it must appear that they have furnished some compensatory additional consideration or have an equity interest in the estate of the debtor after the rights of creditors are fully provided for"); *In re U.S. Truck Co.*, 47 Bankr. 932, 940-41 (E.D. Mich. 1985): *In re Marston Enterprises, Inc.*, 13 Bankr. 514, 517-18 (Bankr. E.D. N.Y. 1981) (contribution of new capital necessary to fund reorganization plan in return for participation in reorganization plan did not violate "fair and equitable" rule, even though intervening classes of creditors received nothing under the plan).

Thus, a more accurate summation of the absolute priority rule would be that a dissenting class of unsecured creditors must be provided for in full before any junior class may receive or retain any property under the plan, unless the junior class contributes to the reorganization enterprise something that is reasonably compensatory and is measurable.

Certainly, a farmer's efforts in operating and managing his farm is essential to any successful farm reorganization, and this yearly contribution is measurable in money or money's worth. Moreover, the reorganization value of the Ahlers' farm exceeds its liquidation value—if the plan is rejected, the unsecured creditors will get nothing, whereas they will receive annual payments if the plan is approved and is successful. The Ahlers' farm operation and management skills are something of a value which would disappear if their farm was liquidated. Because that value cannot be captured for creditors in the event of liquidation, fairness is not violated if their Chapter 11 plan leaves that value in their hands. This view also recognizes the broad rehabilitative purposes of the Bankruptcy Act—to give a debtor with a reasonable chance of success an opportunity for a fresh start. Any other view would deny to most farmers the opportunity to take advantage of the reorganization provisions of the Bankruptcy Act. Accordingly, the farmer should be entitled to participate in the plan to the extent of this contribution, even though more senior claims are not provided for in full under the plan. The only remaining question, therefore, is whether the farmer's new contribution is reasonably equivalent to the equitable ownership interest the farmer would retain under the plan.



We recognize that there is no mathematical formula which the bankruptcy court can apply to make this determination, and that this determination must necessarily depend on the facts in each case. However, the value of the farmer's labor, including the value of his experience and expertise in farming the land, should not be overly difficult to determine. Valuing the retained equitable ownership interest, however, is a more difficult problem.

In *In re U.S. Truck* the court stated that in determining the general worth of the retained interest, a court must necessarily make determinations regarding the future of the debtor as reorganized, and its possible profits. 47 Bankr. at 941-42 (citing *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981)). In *Landau Boat* the creditors argued that the shareholders were retaining equity value without consideration because the debtor corporation, as an ongoing business, was worth more than the shareholders' new contribution. The court in *Landau Boat* stated:

> The commercial value of property consists in the expectation of income from it * * *. Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties * * *. The criterion of earning capacity is the essential one * * * if the allocation of securities among the various claimants is to

> be fair and equitable * * *. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earnings capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance.

13 Bankr. at 792-93 (quoting *Consolidated Rock Products v. DuBois*, 312 U.S. 510, 526 (1941)).

The court found that the debtors' corporation had the potential to be profitable. *Landau Boat*, 13 Bankr. at 793. However, after considering the debtor's financial needs, including debt service, the state of the economy, and the fact that the debtor was in a highly competitive business, the court concluded that the probability of the debtor making a real profit in the next few years was unlikely. *Id.* Thus, the court found that the new investors were making a substantial investment which exceeded any value that could be realized from the business in the near future. *Id.*

Applying these principles to the present case, the Ahlers would not realize any real profit or benefit from their retained equitable ownership interest until the reorganization plan was completed and the secured creditors had been paid the full amount of their allowed secured claims. At this time, the equitable ownership interest would mature. Thus, if the bankruptcy court determines that the value of the Ahlers' yearly contributions of labor, experience, and expertise over the life of the plan will equal or exceed the value of the retained ownership interest at maturity, the dissenting unsecured creditors cannot complain that they have not been accorded their full right of priority against the debtors' assets.[17]

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17. For example, assume that the bankruptcy court values the debtor's labor, experience, and expertise at $40,000 per year, and that the plan provides for yearly living expenses of $12,000. The debtor will have contributed $28,000 per year for his retained equitable ownership interest.



We recognize, of course, that because the profitability of any reorganization plan cannot be determined with mathematical certitude, the possibility exists that the plan may be more profitable than anticipated. If so, and if the equitable ownership interest receives this excess profit, the equitable ownership interest may receive more than the value of its contribution. To avoid this result, the bankruptcy court should require that any cash flow from the operation of the farm in excess of that anticipated in the plan should be paid to the unsecured creditors on a pro rata basis until such time as the unsecured creditors are paid in full without interest. Similarly, if any secured property is sold during the life of the plan, and if the unsecured creditors have not been paid in full, excluding interest, before that date, the bankruptcy court should require that any amount received in excess of that necessary to pay the secured creditors be shared equitably among the unsecured creditors and the ownership interest, based on its contribution at the time the property is sold.[18]

This matter is remanded to the district court with directions that the bankruptcy court take prompt action to comply with this opinion.[19] Each party to this appeal is to bear its own costs.

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18. For example, if the equitable ownership interest has contributed $100,000 at the time the property is sold, and the property constitutes ten percent of the total bankruptcy estate, the ownership interest should be entitled to $10,000 of the excess after the secured creditor has been paid in full. Any amount in excess of this $10,000 should be distributed equitably among the unsecured creditors.

19. While this opinion was being circulated, counsel for Norwest advised the Clerk's Office that an agreement, in substance, to settle the dispute between Norwest and the Ahlers has been reached. The settlement has not yet been reduced to writing and filed with this Court, however. Norwest does not argue that the case is now moot, and points out that no settlement has been reached between the Ahlers and the Federal Land Bank or the Trustee in Bankruptcy. Accordingly, there remain issues in controversy for this Court to resolve. Nothing the Court has said in this opinion should obviate whatever agreement may have been reached between Norwest and the Ahlers.

JOHN R. GIBSON, Circuit Judge, dissenting.

The district court found that Ahlers' liabilities exceed his assets by "a substantial margin," that he "could not * * * be expected to operate profitably," and that his reorganization plan was "utterly unfeasible." *Ante*, at 16. Despite these findings of fact, the court today devises a plan of its own to save Ahlers from liquidation. To do so, the court ignores factual and equitable considerations properly relied upon by the bankruptcy judge in ordering the commencement of adequate protection payments, evades its duty to review expert valuations under the clearly erroneous standard and to refrain from finding facts nowhere in the record, and adopts a view of the absolute priority rule contrary to precedent, logic, and fairness. Understandably sympathetic in the face of admittedly acute difficulties gripping the nation's entire farm economy, the court unabashedly legislates a result which undermines reasonable commercial expectations, and substantially reorders the risks of insolvency borne by farm debtors and their bankers. I respectfully dissent.

## I.

I first take issue with the court's conclusion that the bankruptcy court erred in not granting Ahlers a one year and six week delay in commencing adequate protection payments. 11 U.S.C. § 362(d) (1982) requires the bankruptcy court to grant secured creditors relief from the automatic stay for cause, including the lack of adequate protection. Congress intended that the bankruptcy court, in determining the scope of adequate protection payments, should as nearly as possible provide the secured creditor with its bargained-for rights. *In re Briggs Transportation Co.*, 780 F.2d 1339, 1346 (8th Cir. 1985). We have recognized that the bankruptcy court may order adequate protection payments for reinvestment value lost during post-petition foreclosure delay. *Id.* at 1350.

Congress intended that the bankruptcy court exercise considerable discretion in arriving at adequate protection findings. *See In re Martin*, 761 F.2d 472, 476 (8th Cir. 1985). As has been long and repeatedly recognized, the bankruptcy



court is a court of equity. *Pepper v. Linton*, 308 U.S. 295, 303-04 (1939); *In re Stevenson Associates, Inc.*, 777 F.2d 415, 419 (8th Cir. 1985). To achieve an equitable result, the bankruptcy court must be left free to take a case-by-case approach to varying fact situations. *See In re Briggs*, 780 F.2d at 1346-47. Therefore, "final reconstruction of the creditor's bargain to determine just what interests of the creditor should be afforded protection during the pendency of the automatic stay is a balancing act best left to the discretion of the bankruptcy judge." *Id.* at 1349.

Despite the congressional mandate to defer to the bankruptcy court's discretionary authority, and without making any effort to assess the equitable concerns which the bankruptcy court may have weighed in ordering the commencement of adequate protection payments, the court today renders nugatory, as a matter of law, the banks' bargained-for right to investment return on foreclosure proceeds during the one year and six week period following imposition of the automatic stay. The court achieves this reversal of the bankruptcy court's adequate protection finding by taking judicial notice of "reasonable and established marketing techniques," *ante*, at 12, which it asserts Minnesota lenders employ to accommodate the state notice and redemption provisions. The court, however, fails to acknowledge the host of other equitable concerns that the bankruptcy court was required to consider in reaching its determination. Similarly, it fails to review the bankruptcy court's findings under the clearly erroneous standard. Rather, the court simply disregards these constraints essential to the proper exercise of appellate jurisdiction in an effort to bolster Ahlers' chances of forging a feasible plan for reorganization.

Recognizing the special fact-finding and equitable powers of the bankruptcy court, this court held in both *In re Briggs* and *In re Martin* that adequate protection is a case-by-case inquiry subject to clearly erroneous review. Under these cases, and under the circumstances presented by this case, I cannot say that the bankruptcy court, in its proper exercise of fact-finding and equitable jurisdiction, was clearly erroneous in finding the banks entitled, without delay, to protec-

tive payments on the reinvestment value of the foreclosure proceeds.

## II.

The court today also concludes that the district court erred in holding that Ahlers' reorganization is unfeasible. The court reaches this result by replacing the district court's findings as to the values of Ahlers' land and equipment with findings of its own. I differ with the court's method and with its implicit conclusion that the district court's valuations were clearly erroneous.

Fed. R. Civ. P. 52(a) orders that findings of fact shall not be set aside unless clearly erroneous. As the Supreme Court explained in *Anderson v. City of Bessemer City*, 105 S. Ct. 1504 (1985), if a finding of fact is based on the testimony of one of two or more witnesses, each of whom has told a plausible and coherent story not contradicted by extrinsic evidence, that finding can virtually never be clear error. *Id.* at 1513. Similarly, where there are two permissible views of the evidence, the trial court's choice between them cannot be clearly erroneous. *Id.* at 1512. In light of the teaching of *Anderson v. City of Bessemer City*, I cannot conclude that the bankruptcy court's findings on the values of Ahlers' land and equipment, confirmed by the district court, were clearly erroneous.

Dennis Christensen, a farm manager and real estate appraiser, testified that his assessments were based on land values as of January 15, 1985, approximately six weeks after Ahlers filed under Chapter 11. He testified that he considered land sales in the county immediately west of Nobles County which had taken place within the previous three weeks. He testified that his soil comparisons indicated close similarity between those parcels and Ahlers' parcels. He also based his assessments on conversations with the local assessment official, and with local bankers and lawyers familiar with the local real estate market. He stated that his valuations took into account the reported approximately 24 percent decline in 1984 in the value of good corn and soybean ground in southern Minnesota. Similarly, Arden Harberts, a professional auctioneer who stated that he holds about 60 farm auction sales a year, testified to the value of Ahlers' farm machinery and equipment. Harberts testified that his valuation was based on his experience and knowledge of the current market.



It is true that Christensen's and Harberts' valuations differed widely from those offered by Ahlers. However, the bankruptcy court accepted the testimony of the banks' witnesses. As the bankruptcy court stated: "Mr. Ahlers provided testimony regarding the valuation of the machinery and equipment, candidly stating that his valuation was based on conjecture. Norwest's evidence was by expert testimony based on substantial foundation." Slip op. at 8. The bankruptcy court offered a similar assessment of the land valuation testimony. Slip op. at 6 n.6. In my judgment, the evidence was sufficient to support the findings made by the bankruptcy court. I could not, under the standard articulated in *Anderson v. City of Bessemer City*, hold these findings clearly erroneous.

The district court accepted the bankruptcy court's findings that the valuations offered by the banks' experts were accurate. The majority quarrels with the district court's adoption of these findings, contending that because land prices had fallen since the adequate protection hearing, section 506(a) of the Bankruptcy Code, 11 U.S.C. § 506(a) (1982), requires the district court to revalue Ahlers' parcels. The logic of this argument escapes me. First, nowhere in the record made before the district court is there evidence of a precipitous decline in land values during the period between the adequate protection and confirmation hearings. Second, even if such a decline occurred, the consequences of the court's determination that the land must be revalued are nonetheless dramatic. Under section 506(a), the banks' claims are secured only to the extent of the value of the collateral at the time the plan is confirmed. The court's ruling thus places the loss resulting from the asserted drop in farm land values during the pendency of the automatic stay entirely on the banks. The House Report which the court cites falls far short of supporting its assertion that Congress intended such a dramatic shift in the risk of loss. Nor do I believe such a shift is either reasonable or fair. For during the stay period, the banks were utterly without recourse. Thus, I cannot say that the district

court acted improperly in adopting the bankruptcy court's findings.

In selecting valuation figures even lower than the estimates given by Ahlers, as is suggested in the Appendix, the court today ignores the plausible and coherent testimony in the record that would support the bankruptcy court's findings, which the district court adopted. Instead, the court simply substitutes wholesale findings of fact of its own. It makes no effort to analyze the accepted testimony, as required by *Anderson v. City of Bessemer City*. The court's action is especially ironic in light of the bankruptcy court's findings that even were it to accept Ahlers' valuations, it still would conclude that the banks would be substantially undersecured. The irony is heightened when the court orders that should the farming operation produce profits above those projected, these should be distributed to the unsecured creditors. This is little more than contemplating the distribution of a mirage.

Under the principles of *Anderson v. City of Bessemer City*, I would conclude that the findings made by the bankruptcy court and confirmed by the district court were not clearly erroneous.

## III.

The court also decides today that "experience, knowledge, and labor," *ante*, at 3, is the equivalent of capital. It thus would allow Ahlers to force upon the impaired unsecured creditors a reorganization plan which would permit Ahlers to participate in the plan on the strength of his promise to later contribute his expertise and efforts to the plan. This reasoning works an expansion of the rule of absolute priority that is unprecedented, illogical, and unfair.

The absolute priority rule, established in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), and codified at 11 U.S.C. § 1129 (b)(2)(B)(ii) (West Supp. 1986), prohibits a debtor from participating in a reorganization plan unless unsecured creditors' claims are fully satisifed. The rule assures that the plan is fair and equitable by protecting unsecured creditors from suffering losses greater than they reasonably could have foreseen. Case law has developed a



narrow corollary to the absolute priority rule. Where substantial fresh capital, ot its equivalent, is essential to the success of a plan, the debtor may, over the objection of impaired unsecured creditors, make such fresh contributions and participate in the plan to the extent of the contributions. This corollary recognizes that a reorganized going concern generally is worth more than its liquidated assets. If reorganization requires debtor participation, and if the impaired creditors suffer no net loss by virtue of the debtor's concomitant contribution, otherwise lost value is captured without violating the fair and equitable requirement.

The Supreme Court recognized this corollary to the absolute priority rule in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). There, however, the Court held that a reorganization plan of an insolvent corporation was not "fair and equitable" because it preserved shareholders' interests without any fresh contribution of capital by such shareholders and without full satisfaction of creditors' claims. Despite this holding, the court seizes upon dicta in *Los Angeles Lumber*, that "the stockholder's participation must be based on money or money's worth," *id.* at 122, to conclude that "[c]ertainly a farmer's efforts * * * [are] measurable in money or money's worth," and thus may be used to override the dissent of legitimate creditors to Ahlers' retention of an interest in the reorganization plan. Indeed, even the observation in *Los Angeles Lumber* dealt not with an exchange of a promise to make future contributions of labor and skill for equity participation in a reorganization plan, but with an offer by shareholders in a corporation to make immediate and substantial contributions of new and needed capital. These distinctions, I believe, render the court's reliance on the "money's worth" dicta unsound.

The Court in *Los Angeles Lumber* suggested that when a cash contribution is impossible, " 'a [creditor's] interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock,' " *id.* at 117 (quoting *Boyd*, 228 U.S. at 508), or " 'through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation,' " *id.* (quoting *Kansas City Terminal Railway Co.*

*v. Central Union Trust Co.*, 271 U.S. 445, 454-55 (1926)). These examples of permissible cash substitutes, undoubtedly what was intended by the "money's worth" phrase, are distinctly capital in nature. But in rejecting a plan similar to that hypothesized today, the Court made clear that non-capital contributions, such as

> financial standing and influence in the community [which] can provide a continuity of management constitute[s] no legal justification for issuance of new stock to [the debtor]. Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests, would serve as easy evasions of the principle of full or absolute priority* * *.

*Id.* at 122. The Court continued:

> Such items * * * have no place in the assets column of the balance sheet of the new company. They reflect merely vague hopes or possibilities. As such, they cannot be the basis for issuance of stock to otherwise valueless interests.

*Id.* at 122-23 (footnotes omitted). Like *Los Angeles Lumber*, every case the court cites to support the exchange of labor for equity participation deals with a proposed capital contribution. To my knowledge, the court today writes the first labor contribution case. The court's expansion of the narrow corollary to the rule of absolute priority, therefore, is supported neither by *Los Angeles Lumber* nor by any other precedent.

The analysis in *Los Angeles Lumber* also highlights the extreme illogic of the analogy from capital contributions to contributions of labor and expertise. First, capital, not labor, is the means of exchange in our economy. Labor cannot easily be turned to another use; it is not liquid. Therefore, a contribution of labor does not provide the same certain protection to the unsecured creditor as does one of capital. Second, while the value of capital is fixed, the value of a farmer's experience, knowledge, and labor to a failing farm, like the value of "financial standing and influence in the



community," *Los Angeles Lumber*, 308 U.S. at 122, is a matter of grave speculation, again injecting uncertainty into the bargain. Finally, the capital contribution is executed prior to plan approval. Here, it is only upon the promise of future contributions of labor that creditors must rely for protection. How are we to bind the debtor to an agreement to contribute labor? Surely the court does not suggest that we are empowered to order specific performance of labor obligations. *See Karrick v. Hannaman*, 168 U.S. 328, 335-36 (1897). Does not a plan involving a contribution hypothesized by the court "reflect purely vague hopes or possibilities," *id.* at 123, rather than the certainty a finding of feasibility requires?

These distinctions render expansion of the capital contribution corollary to the absolute priority rule not only illogical, but also violative of the "fair and equitable" requirement. Just as an unsecured creditor obviously must foresee the possibility of the debtor's insolvency and subsequent reorganization, so too may he fairly expect that if insolvency occurs, his recovery will not be impaired by the debtor's retention of an interest in the plan. Because an agreement to contribute labor cannot be sufficient to justify participation, a plan including such a contribution is not "fair and equitable."

I do not believe the section 1129(b)(2)(B)(ii) rule of absolute priority would permit Ahlers to participate in the reorganization plan on the strength of his promise to contribute his "experience, knowledge, and labor" to the plan. Therefore, I would affirm the district court's ruling that the plan was unfeasible.

## IV.

The motivation behind the court's decision is commendable. Farm bankruptcies have reached epidemic proportions and farmers are being torn from their livelihood. Nonetheless, I cannot abide the solution the court today proposes. As the court acknowledges, the district court found that Ahlers' plan for reorganization was "utterly unfeasible" because his "current liabilities exceeded current assets by a substantial margin" and because he "could not * * * be expected to operate profitably." *Ante*, at 16. It is only through the court's disre-

gard of its proper role that it can coax from the record, and from sources outside the record, its conclusion that a razor thin margin might exist by which Ahlers could feasibly reorganize. If there is to be an adjustment to the relationship between the farmer and the farmer's bank, serious policy questions are presented which can best be considered by the Congress. We, however, are advised to confine our efforts to deciding cases on the law as written and on the facts as found.

I respectfully dissent.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.



# APPENDIX I

The values of the land, equipment, and production costs represented in this Appendix were derived by this Court from the best available evidence in the record presented to it, and from published studies by the University of Minnesota. The commodity prices were based upon recent cash grain prices at the Fulda, Minnesota, Independent Cooperative grain elevator. The sole purpose of this Appendix is to illustrate that, based upon the record before this Court, the Ahlers may be able to present a feasible reorganization plan. We emphasize, however, that this plan, as well as the values contained therein, is merely illustrative, and is not binding on the parties or the bankruptcy court. On remand, the bankruptcy court is free to determine these values as of the date of the confirmation hearing in light of the reorganization plan submitted by the Ahlers to determine if that plan is feasible.

## AHLERS' INCOME

A. 830 Tillable Acres
550 owned by Ahlers
280 rented by Ahlers
Rental agreement is a standard
40%/60% share crop payable before expenses.

B. By participating in the recently enacted federal farm program, the Ahlers' projected income for 1986 would be as follows:

1. *Corn* (332 acres)

a. 415 acre base
20% removed from production
110 bu./acre yield and base
415 acres × (80%) = 332 acres
332 acres × 110 bu./acre = 36,520 bu.
36,520 bu. × $3.50/bu.[1] = $ 127,820

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1. When the deficiency and payment-in-kind (PIK) payments of the federal farm program are considered, the Ahlers can expect to receive approximately $3.50 per bushel for their corn in 1986. *See* K. Bailey, V. Byron, & J. Houck, *The Food Security Act of 1985: Implications for Minnesota's Farm Economy*, University of Minnesota Department of Agriculture and Applied Economics Staff Paper 86-11 at 38 (March 1986). This $3.50 per

b. Expenses

(1) *Share Crop* (60/40)
95 rented acres in corn
95 acres × 110 bu./acre = 10,450 bu.
10,450 bu. × (40%) = 4,180 bu.
4,180 bu. × $3.50 = $( 14,630)

(2) *Production*

(a) Seed = $( 8,250)

(b) Fertilizer = $( 9,000)

(c) Herbacide = $( 3,306)

(3) *Insurance*

(a) Federal Crop
332 cres × $10.75/acre $( 3,570)

c. Total Subnet on Corn $ 89,064

2. *Soybeans* (375 acres)

a. Anticipated Yield = 35 bu./acre
375 acres × 35 bu./acre = 13,125 bu.

b. Present Price = $5.07/bu.
13,125 bu. × $5.07/bu. = $ 66,544

bushel figure represents a deficiency payment of approximately $1.00 per bushel, a PIK payment of approximately $0.75 per bushel, and a projected market price of approximately $1.75 per bushel. *Id. See also* Interview with Al Kluis, Ag Marketing Services in Mankato, Minnesota at 4 (December 16, 1985). As the market price increases or decreases, the deficiency payment is adjusted accordingly; therefore $3.50 per bushel represents a fairly constant price for the 1986 corn crop.



c. Expenses

(1) *Share Crop* (60/40)
135 rented acres in soybeans
135 acres × 35 bu./acre = 4,725 bu.
4,725 bu. × (40%) = 1,890 bu.
1,890 bu. × $5.07 = ( $9,582)

(2) *Production*

(a) Seed = $( 3,000)

(b) Herbacide = $( 2,520)

(3) *Insurance*

(a) Federal Crop
375 acres ×
$5.80/acre = $( 2,175)

d. Total Subnet on Soybeans = $ 49,267

3. *Oats* (30 acres)

a. Anticipated yield = 80 bu./acre
30 acres × 80 bu./acre = 2400 bu.

b. Present Price = $0.98/bu.
2400 bu. × $0.98/bu. = $ 2,352

c. Expenses

(1) *Production*

(a) Seed = $ (363)

(b) Fertilizer = $ (490)

(c) Herbacide = $ (60)

d. Total Subnet on Oats = $ 1,439

4. Total Subnet on Grains = $ 139,770

5. Other Income

a. 700 Feeder Pigs = $ 73,500

6. Total Subnet Farm Income = $ 213,270

7. Other Expenses

| | |
|---|---|
| a. Fuel = | $( 11,900) |
| b. LP for Grain Dryer = | $( 5,000) |
| c. Repairs and Maintenance = | $( 7,500) |
| d. Fertilizer for Set Aside = | $( 395) |
| e. Alfalfa Seed = | $( 768) |
| f. Feeder Pig Expenses = | $( 61,250) |
| Total Net Farm Income = | $ 126,457 |

## II. CREDITOR CLAIMS

A. *Parcel "A" (FLB Claim "F")*
FLB first mortgage in 240 acres

| | |
|---|---|
| Loan balance = | $ 343,252 |
| Allowed secured claim 240 acres = | $ 163,300[2] |
| Total unsecured claim = | $ 179,952 |

1. Plan = issue a new note for the amount of the allowed secured claim with interest at 12.5% and principal payable annually based upon a 30 year amortization.[3]

   The Ahlers' yearly payments to the FLB on this secured claim would be $21,026 as compared to $27,252 under the present mortgage.

2. The values of land and equipment shown in this appendix were derived by this Court from the record presented to it and from published studies by the University of Minnesota for the sole purpose of making a determination as to whether it is reasonably probable that the Ahlers can succeed. The bankruptcy court is free to determine values as of the date of confirmation on remand.

3. The bankruptcy court is free to determine the appropriate interest rates and length of mortgage for the new mortgages on land and equipment from the record on remand. The rate should reflect that generally in use at the time the decision to approve or disapprove the plan is made. If the interest rate is less than that used in this appendix, the annual payments on the land would be reduced by about $2,300 for each percentage point decrease.



2. Norwest Bank has a second mortgage in this parcel of land, but no equity; it would receive nothing from this land under either reorganization or liquidation.

B. *Parcel "B" (FLB claim "E")*
FLB first mortgage in 160 acres

| | |
|---|---|
| Loan balance = | $ 160,668 |
| Allowed secured claim 160 acres = | $ 106,500 |
| Total unsecured claim = | $ 54,168 |

1. Plan = issue a new note for the amount of the allowed secured claim with interest at 12.5% and principal payable annually based upon a 30-year amortization.

   The Ahlers' yearly payments to FLB on this secured claim would be $13,713 as compared to $18,173 under the present mortgage.

2. Norwest Bank has a second mortgage in this parcel of land, but no equity; it would receive nothing from this land under either reorganization or liquidation.

C. *Parcel "C" (FLB claim "G"– Norwest Claim "C")*
FLB first mortgage in 80 acres
Norwest second mortgage in same

| | |
|---|---|
| FLB loan balance = | $ 30,184 |
| Value of land = | $ 62,480 |
| Equity remaining for Norwest = | $32,296 |

1. Plan for FLB = The Ahlers would affirm the original note and mortgage and would make payments pursuant to them. There is one principal and interest payment in default, and this payment, if it has not already been made, would be deferred to the end of the loan period.

   Under this plan, the Ahlers' yearly payments to the FLB would continue to be $2,849.25

2. Plan for Norwest discussed supra in section F.

D. *Parcel "D" (FLB Claim "D" – Norwest Claim "C")*
FLB first mortage in 80 acres
Norwest second mortage in same

| | |
|---|---|
| FLB loan balance = | $ 6,014 |
| Value of land = | $ 62,480 |
| Equity remaining for Norwest = | $ 56,466 |

1. Plan for FLB = The Ahlers would affirm the original note and mortage and would make payments pursuant to them. There is no payment in default. Under the plan, the Ahlers' yearly payments to the FLB would continue to be $855.

2. Plan for Norwest discussed supra in section F.

E. *Summary of FLB claims*

1. Loan balances

| | |
|---|---|
| a. $343,252 | |
| b. $160,668 | |
| c. $ 30,184 | |
| d. $ 6,014 | |
| Total | $ 540,118 |

2. Amount repaid under plan

| | |
|---|---|
| a. $163,300 | |
| b. $106,500 | |
| c. $ 30,184 | |
| d. $ 6,014 | |
| Total | $ 305,998 |
| Total unsecured debt to FLB | $ 234,120 |



F. *Norwest land claims*
Allowed secured claims in land

| | |
|---|---|
| 1. Parcel A = | $ 0 |
| 2. Parcel B = | $ 0 |
| 3. Parcel C = | $ 32,296 |
| 4. Parcel D = | $ 56,466 |
| Total | $ 88,762 |

Plan = Norwest would retain a second mortgage in this land, and would be issued a new note for the amount of the allowed secured claim with 12.5% interest and principle payable annually based on a 30-year amortization.
Under this plan, yearly payments to Norwest on this secured claim would be $11,429.

G. *Norwest machinery claim*

Allowed secured claim of machinery and farm equipment based on estimate of Vander Grift which most closely reflects estimates of farm machinery "Bluebook" and "Iowa Hotline" auction guide = $ 66,300

Plan = Norwest would retain a lien on the machinery and would be issued a new note for the amount of the allowed secured claim with 10% interest and principle payable on a 6-year amortization.

Under the plan, the Ahlers' yearly payments to Norwest on this allowed secured claim would be $15,241.

H. *Summary of Norwest Bank claims*

| | |
|---|---|
| 1. Loan balance = | $ 450,468 |
| 2. Amount of secured claims repaid under the plan: | |
| a. Parcel C = | $ 32,296 |
| b. Parcel D = | $ 56,466 |
| c. 1984 crop proceeds = | $ 43,000 |
| d. Cattle proceeds = | $ 12,000 |
| e. Farm machinery = | $ 66,300 |
| Total = | $210,062 |
| Total unsecured debt to Norwest Bank = | $240,406 |

I. *John Deere Credit claim*

| | |
|---|---|
| Balance due on JD 7720 combine with corn and flex head = | $ 35,791 |
| Value/allowed secured claim = | $ 26,000 |
| Unsecured claim = | $ 9,791 |

Plan = John Deere would retain a first lien on the combine and would be issued a new note for the amount of the allowed secured claim with 10% interest and principal payments based on a 6-year amortization.

Under this plan, the Ahlers' yearly payments to John Deere Credit would be $5,977.



J. *CCC Claim*

| | |
|---|---|
| Balance due on steel bin = | $ 3,337 |
| Value/allowed secured claim = | $ 1,500 |
| Unsecured claim = | $ 1,837 |

Plan = CCC would retain a first lien in the steel bin and would be issued a new note for the amount of the allowed secured claim with 10% interest and principal payments based on a 6-year amortization.

Under this plan, the Ahlers' yearly payments to CCC would be $344.82.

K. *GMAC Claim*

| | |
|---|---|
| Balance due on 1981 Pontiac Bonneville deisel automobile = | $ 2,900 |

Plan = Ahlers would pay the full amount of the debt over three years at 10% interest.

Yearly payment to GMAC $1,169.

L. *Total Claims*

| | | | |
|---|---|---|---|
| 1. FLB | = | $540,118 | |
| a. Secured | = | 305,998 | |
| b. Unsecured | = | 234,120 | $234,120 |
| 2. Norwest | = | $450,468 | |
| a. Secured | = | 210,062 | |
| b. Unsecured | = | 240,406 | $240,406 |
| 3. John Deere | = | $ 35,791 | |
| a. Secured | = | 26,000 | |
| b. Unsecured | = | 9,791 | $9,791 |
| 4. CCC | = | $ 3,337 | |
| a. Secured | = | 1,500 | |
| b. Unsecured | = | 1,837 | $ 1,837 |
| 5. GMAC | = | $ 2,900 | |
| a. Secured | = | 2,900 | |
| b. Unsecured | = | 0 | $ 0 |
| 6. Total Debt with accumulated interest (approx.) | = | $1,040,000 | |
| 7. Total secured claims paid under plan | = | $546,460 | |
| 8. Total unsecured claims remaining | = | $493,540 | |



## III. LIQUID ASSETS

| | |
|---|---|
| A. 1984 grain inventory = Norwest has a first lien on this amount and this inventory would immediately be turned over to Norwest. | $ 43,000 |
| B. 1984 cattle sale = Norwest has a first lien on this amount and these proceeds would immmediately be turned over to Norwest. | $ 12,000 |
| C. 1985 grain inventory = Approximately $57,000 will be needed to plant and harvest the 1986 crop. After the first year's crop is harvested, the $115,345 would be subject to further order of the bankruptcy court. | $115,345 |

## IV. FUTURE OF PLAN

The Ahlers have approximately $37,854 per year extra which could be paid to unsecured creditor claims. Over the 30 years of the plan, this $37,854 would yield $1,135,620 exclusive of interest. After six years, Ahlers would have an additional $23,000 to be applied to the claims of the unsecured debtors ($493,540). If all payments were promptly made, these claims would be fully retired within 10.5 years.

Thus, under this plan, the secured creditors would be paid 100% of their allowed secured claims, with interest, and 100% of their unsecured claims, without interst, and the Ahlers would remain on their farm. If liquidated, the creditors would receive less than 100% of allowed secured claims (after exemptions were deducted), none of their unsecured claims, and the Ahlers would be deprived of the opportunity to work their farm.

## V. BALANCE SHEET

| | | |
|---|---|---|
| Total Income (Less Mary Ahlers' income | | $126,457 |
| A. Payments over 30 years | | |
| *FLB land* | | |
| Parcel A | $21,026 | |
| Parcel B | 13,713 | |
| Parcel C | 2,849 | |
| Parcel D | 855 | |
| | $38,443 | $( 38,433) |
| 2. *Norwest land* | | |
| Parcels C & D = $11,429 | | $( 11,429) |
| Total land payments | | $( 49,872)[4] |
| B. Payments over 6 years | | |
| 1. Equipment | | |
| a. Norwest Equipment = | $15,241 | |
| b. JD Credit = | 5,977 | |
| c. CCC = | 344 | |
| d. GMAC (3 years) = | 1,169 | |
| | $22,731 | $(22,731) |

4. These payments would be reduced by about $2,300 per year for each percentage point that the rate is reduced below 12.5%.



| | | |
|---|---|---|
| C. Other payments | | |
| 1. Living expenses = | $14,000 | |
| (less Mary Ahlers' $2,500 income | $(11,500) | |
| 2. Tax and priority claims | $( 4,500) | |
| Total yearly expenses | $(88,603) | |
| Total yearly net income | | $ 126,457 |
| Available for distribution yearly to the unsecured creditors | | $ 37,854[5] |

5. This sum would be increased to $60,585 after the equipment restructured secured loans were paid off.

# United States Court of Appeals
## FOR THE EIGHTH CIRCUIT

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No. 85-5396

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In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

James R. Ahlers and
Mary M. Ahlers,
Appellants,

vs.

Norwest Bank Worthington
and Federal Land Bank,
Appellees.

Appeals from the United States District Court for the District of Minnesota.

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No. 85-5397

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In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

Norwest Bank
Worthington, N.A.,

Appellee,

vs.

James R. Ahlers and
Mary M. Ahlers,
Appellants.

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Filed: September 17, 1986

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Before LAY, Chief Judge, and HEANEY, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, BOWMAN and WOLLMAN, Circuit Judges, en banc.

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## ORDER DENYING PETITION FOR REHEARING EN BANC

The petition of Norwest Bank Worthington and the Federal Land Bank for rehearing en banc is denied.

**HEANEY,** Circuit Judge.

This Court's opinion recognizes that farm prices and land values have fallen dramatically since the mortgages were executed and that present farm income is simply inadequate to repay the original debt. The banks' losses will be the same whether the debt is restructured to enable the Ahlers to continue operating the farm or the land is sold at a liquidation sale. Congress intended to permit farmers to reorganize if they have a reasonable chance of success. The panel opinion simply reflects that intent.

Contrary to the views expressed by the dissenters, the application of the absolute priority rule was not raised for the first time in the panel opinion. Norwest took the position before the district court and before this Court in its brief and oral argument that even if adequate protection were offered and a feasible plan presented, no plan for reorganization could be approved because the debtor proposed to retain an interest in the farm without paying Norwest the amount of its claim in full. It stated:

> [D]ebtors propose to treat a large portion of Norwest's claim as unsecured. Norwest disagrees with this assertion, but even if the Debtors successfully treat Norwest as unsecured to some degree, *this plan is unconfirmable over the vote of a non-consenting class of unsecured creditors if the Debtors retain any interests in their property and the unsecured creditors are not paid in full on the effective day of the plan.* 11 U.S.C. § 1129(a) (8) and (b). *In re Pecht,* 53 B.R. 768, 770 (Bankr. E.D. Va. 1985). Since Norwest as an unsecured creditor would not consent to a plan in which the Debtors retain anything, unless Norwest is paid in full, a non-liquidating plan could not be confirmed unless Norwest was outvoted within its class of unsecured creditors.



Brief for Norwest at 22-23 (emphasis added, footnote omitted); *see also* Supplemental brief of Norwest before the district court at 4.

At oral argument counsel for the Federal Land Bank was asked the following question:

> Q. Is it your position that, as it is your colleague's, that unsecured creditors can prevent the confirmation of a plan which would provide for the payment to secured creditors of the value of their loan at the time the plan was filed?
>
> A. Yes, as counsel for Norwest correctly pointed out under section 1129(b) (2), your Honor, an unsecured creditor must receive property of a value of his unsecured claim at the time of confirmation if the debtor proposes to retain any interest in the property at that time.

In view of the fact that both the Federal Land Bank and Norwest took the position outlined above, one could only conclude that a plan of reorganization could not be approved for the Ahlers because they proposed to retain an interest in the property. Thus, we had no alternative but to decide whether Norwest and the Federal Land Bank could block a petition for reorganization solely on the basis of the absolute priority rule. Inasmuch as it was abundantly clear from the record that the Ahlers would be unable to infuse any new cash into the farm, the key question, implicit in the application of the absolute priority rule, was whether their work and labor could be substituted for cash. We answered that question in the affirmative.

Further support for this analysis is to be found in the fact that the dissenting opinion, as well as the majority opinion, saw fit to address the merits of the matter.

**ARNOLD,** Circuit Judge, dissenting from the denial of rehearing en banc.

I vote to grant the petition for rehearing en banc. At this stage of the case, I am inclined to agree with the view of the law expressed by my Brother Gibson on the question of the legal effect of a debtor's promise to contribute his own labor, skill, and experience to the future of the enterprise. But because the petition for rehearing en banc has been denied, the Court en banc will not have the benefit of briefing, argument, and conference. I therefore forego any more definite statement as to this time.

**JOHN R. GIBSON,** Circuit Judge, dissenting from denial of rehearing en banc, joined by Judges Ross, Fagg and Bowman, Circuit Judges.

Five participating judges vote to grant rehearing en banc in this case and four vote to deny. The majority does not prevail, however, as 28 U.S.C. § 46(c) permits rehearing en banc only when "ordered by a majority of the circuit judges who are in regular active service." With the court now at its full strength of ten judges in regular active service, a vote of six is required for en banc consideration.

The failure to consider this case en banc is particularly regrettable. The court has altered the relationship between debtor and creditor, invading serious policy issues properly the concern of Congress, and in doing so has substituted its own findings of fact for those made by the bankruptcy and district courts. I need not further belabor the arguments in my original dissent.

The court holds that experience, knowledge, and labor is the equivalent of capital. *Ahlers v. Norwest Bank Worthington,* No. 85-5396, slip op. at 3, 28-30. This is directly contrary to the Supreme Court's decision in *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106 (1939). Furthermore, this issue was not raised in either the bankruptcy court or the district court, and the parties did not discuss this issue on appeal. This issue first appeared, suddenly and without warning, in the panel opinion and was not addressed by counsel until filing the motion for rehearing en banc.

This court has long recognized the principle that we will not consider, nor reverse on, an issue not presented to the court



below. *Spear v. Dayton's,* 771 F.2d 1140,1144 (8th Cir. 1985); *Larsen v. Erickson,* 549 F.2d 1136,1139 (8th Cir. 1977); *Cato v. Collins,* 539 F.2d 656, 662 (8th Cir. 1976); *Morrow v. Greyhound Lines, Inc.,* 541 F.2d 713,724 (8th Cir. 1976); *Hunt v. Pan American Energy, Inc.,* 540 F.2d 894, 899 (8th Cir. 1976), *cert. denied,* 429 U.S. 1062 (1977). Reluctance to depart from this principle was expressed in *Parker v. Corrothers,* 750 F.2d 653, 658 (8th Cir. 1984), but the issue was considered because, unlike the present case, both parties at oral argument and the government in its brief addressed the question on appeal. As Justice Blackmun stated in *Singleton v. Wulff,* 428 U.S. 106, 121 (1976), "injustice was more likely to be caused than avoided by deciding the issue without petitioners having had an opportunity to be heard." To depart from this fundamental restraining principle without briefing and argument of counsel, and to reach a conclusion in conflict with Supreme Court authority on an issue presenting serious national policy considerations, is simply a usurpation of appellate judicial authority. Now the court refuses the opportunity to rehear and correct this excess by the slimmest of margins.

Certainly, in some future case, there may be sufficient votes to enable this court to revisit the issue. This case, however, can now be resolved only in the Supreme Court. We are left to hope that, upon proper petition, it will grant certiorari.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

# United States Court of Appeals
## FOR THE EIGHTH CIRCUIT

No. 85-5396

In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

James R. Ahlers and
Mary M. Ahlers,
Appellants,

v.

Norwest Bank Worthington
and Federal Land Bank,
Appellees.

On Motion for Clarification of Order Denying Petition for Rehearing En Banc, Motion to Vacate or Amend Order and Motion for Stay of Issuance of Mandate.

No. 85-5397

In Re:
James R. Ahlers and
Mary M. Ahlers,
Debtors.

Norwest Bank
Worthington, N.A.,
Appellee,

v.

James R. Ahlers and
Mary M. Ahlers,
Appellants.

Filed: October 16, 1986

Before LAY, Chief Judge, and HEANEY, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, BOWMAN and WOLLMAN, Circuit Judges En banc.

## ORDER

The motion of the Federal Land Bank to vacate this Court's order of September 17, 1986, is denied.

The motion of the Federal Land Bank to grant a stay of mandate for a period of ninety days to permit it to petition for a writ of certiorari to the United States Supreme Court is denied. This Court, however, does grant a stay of mandate until December 8, 1986, to permit any party to this appeal to file a petition for a writ of certiorari with the United States Supreme Court.

The motion of the Federal Land Bank for clarification of this Court's order of September 17, 1986, is denied. We do, however, in response to the request of the Federal Land Bank, state that Judge Frank J. Magill did not participate in consideration of the petition for rehearing en banc because he had recused himself from such participation in light of the fact that he had represented the Federal Land Bank shortly before appointed to this Court.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

## UNITED STATES BANKRUPTCY COURT

DISTRICT OF MINNESOTA
THIRD DIVISION

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In Re:

James R. Ahlers and
Mary M. Ahlers,
Debtors.

BKY 3-84-2206
ORDER

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At St. Paul, Minnesota.

This matter is before the Court on several motions. One motion was brought by Norwest Bank-Worthington (Norwest) for relief from the automatic stay. A preliminary hearing was held on that motion on February 7, 1985, and resulted in this Court's interim Order of February 8, 1985, regarding: adequate protection; certain injunctive relief; and use of cash collateral. Final hearing was held on February 27, 1985. A second motion heard on February 27, 1985, was the Debtors' request that the Court reconsider its February 8 Order. A third motion heard was a request by Federal Land Bank of St. Paul (FLB) for relief from stay. The fourth and final motion heard on February 27 was initiated by the Court and concerns retention by the Debtors' attorneys of a retainer fee received prior to commencement of the case. The following appearances were made at the February 27 hearing: Michael Stewart and Linda Rusch attorneys for Norwest; David Kastelic attorney for FLB; John Hedback attorney for U.S. Trustee; and William Needler, James Truax and Charles Zimmerman attorneys for the Debtors.

Based on testimony taken, documentary evidence received, and on arguments of counsel, the Court makes this Order pursuant to the Federal Rules of Bankruptcy Procedure.

### I.

The Debtors are debtor-in-possession farmers who filed for relief under 11 U.S.C. Chapter 11 on November 30, 1984. According to their schedules, the Debtors owned creditors $1,042,301.00, $955,767.00 of which was secured, when the

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petition was filed. The schedules reflect property owed by the Debtors having a value of $696,499.00.

There appears a discrepancy in the schedules regarding the value and amount of the Debtor's 1984 crop inventory. Their Statement of Financial Affairs discloses an inventory taken on November 19, 1984, in the amount of $223,500.00, while their Schedule B-2 values the inventory on November 30 at $119,500.00. The schedules do not reflect, and the Debtors have not explained, the circumstances of the apparently missing $104,000.00 in crop inventory.[1]

Norwest is scheduled as a secured creditor with a claim in the amount of $499,528.00, which is represented as noncontingent, liquidated and undisputed. The schedules disclose that the Debtor's crop inventory, equipment, machinery and certain real estate mortgages secure the indebtedness to Norwest. Total value of this security is represented in the schedules to be $256,215.00. Additionally, the parties agree that the Debtors had, on the date of filing, $23,779.00 cash deposit which is Norwest's cash collateral from the prepetition sale of livestock.

FLB is scheduled as a secured creditor with a claim in the amount of $463,325.00, which is represented as noncontingent, liquidated and undisputed. The schedules disclose that first mortgages on all the Debtor's real estate, represented as having a total value of $420,000.00, secure and indebtedness to FLB.

## II.

At the hearing on February 7, 1985, regarding Norwest's motion for relief from stay, Norwest informed the Court that it did not agree with the values assigned to its security by the Debtors. No testimony was taken at the hearing due to unanticipated and unavoidable absence of Norwest's witness who was expected to testify on the valuation issue. During the

1. The Court asked Mr. Needler about this at the February 7, 1985, hearing and he stated that he was unable at the time to furnish an explanation. James Ahlers testified at the February 27 hearing, but not regarding the discrepancy.



course of the hearing, it was disclosed that the Debtors were using a portion of their crop inventory to feed hogs in which Norwest had no security interest. The Debtors informed the Court through their attorney, Mr. Needler, that they had on February 7, just prior to hearing, filed a disclosure statement and certain adversary proceedings challenging the validity of Norwest's secured position. Additionally, the Debtors made an oral motion for use of Norwest's cash collateral for living expenses. Norwest agreed to a one-time payment to the Debtors for this purpose in the amount of $2,000.00.

Based on the Court's understanding of the Debtors' schedules and the representations made at the February 7, 1985 hearing, the Court continued hearing on Norwest's request for relief from stay to February 27, 1985, for final hearing and, on February 8 issued an interim Order: (1) requiring that the Debtors make, on or before February 20, 1985, an adequate protection payment to Norwest in the amount of $1,795.00; (2) enjoining the Debtors from further use of corn in which Norwest claims a security interest, without payment to Norwest in advance at the rate of $2.30 per bushel for corn to be used; and (3) allowing the Debtors' use of Norwest's cash collateral in the limited amount of $2,000 for living expenses.[2] The adequate protection payment of $1,795.00 had not been made as of the February 27 hearing, and in the meantime, FLB filed its motion for relief from stay.

On February 27, 1985, a complete evidentiary hearing was held on the pending motions for relief from stay brought by Norwest and FLB. Hearing on the Debtors' motion for reconsideration of the Court's February 8 Order was included in the proceeding. The following discussion deals with FLB's motion first because it holds first mortgages on all of the Debtors' real estate and its position must be understood in dealing with Norwest's motion.

## III.

FLB holds first mortgages based on separate notes covering the following described property of the Debtors located in

2. The Order also scheduled a hearing for February 27, 1985, regarding retention by the Debtors' attorneys of their prepetition retainer fee.

Section 11, T-104 N, R-41 W, with the principal balances shown as of the date of filing:

| | | |
|---|---|---|
| Parcel A | SW-1/4 and W-1/2 of SE-1/4 | $335,403.50 |
| Parcel B | NW-1/4 | 152,168.05 |
| Parcel C | E-1/2 of SE-1/4 | 31,500.00 |
| Parcel D | E-1/2 of NE-1/4 | 6,783.08 |

Valuation of these parcels is disputed between the parties. Their respective claims regarding values are outlined below:

| | FLB and NORWEST | DEBTORS |
|---|---|---|
| Parcel A | $230,000.00 to $280,000.00 | $168,000.00 |
| Parcel B | $150,000.00 to $160,000.00 | 112,000.00 |
| Parcel C | $88,000.00 | 56,000.00 |
| Parcel D | 156,000.00[3] | 60,000.00 |
| TOTALS | $624,000.00 (using low figure for A&B) | $396,000.00 |

FLB seeks relief from the stay to foreclose its mortgage on Parcels A and B. Regardless of which valuations are correct, it is apparent that FLB is substantially undersecured regarding these parcels. Furthermore, the Debtors are in serious default on both underlying notes. An interest payment came due on the note secured by Parcel A on January 1, 1985, in the amount of $27,251.53. A payment came due on the note secured by Parcel B on January 1, 1985, in the amount of $18,173.31. The interest rate applicable to both loans is 12 percent. Neither payment has been made.

Under these circumstances, FLB is entitled to adequate protection payments during the pendency of this case or, in the absence of such payments, it is entitled to relief from stay. *Lend Lease v. Briggs Transportation Co. (In re Briggs Transportation Co.*, Civ. 3-84-224 (D. Minn. Sept. 26, 1984) *revg.* 35

3. Valuation figures regarding Parcels C and D attributable to FLB were furnished through testimony of Norwest's appraiser. FLB does not dispute these valuations for purposes of this proceeding.



B.R. 210 (D. Minn. 1984); *Crocker Nat'l Bank v. Am. Mariner Industries, Inc.*, 734 F.2d 426 (9th Cir. 1984). These cases recognize that an undersecured creditor is entitled to compensation as adequate protection for the delay of enforcing contractual repossession and foreclosure rights during the interim between filing of the petition and confirmation of a plan. It is the present value of that interest, the opportunity lost, that must be protected.

In this case, FLB is clearly without adequate protection of its interest from the post-petition date of default, January 1, 1985. The Debtors have made no offer of adequate protection,[4] but insist that FLB is not entitled to any because it retains its secured position and the real estate is not depreciating.[5] This simply ignores the law in the District of Minnesota as stated in *Lend Lease v. Briggs Transportation Co., supra.*

Absent some other reasonable and appropriate offer of adequate protection, it is apparent to the Court that under *Lend Lease* the Debtors would be required to make periodic payments to FLB of interest on the underlying value of the collateral in order to maintain the §362 stay. The court concludes for purposes of this proceeding that the value of Parcel A is $230,000.00 and the value of Parcel B is $150,000.[6]

The Debtors, therefore, would need to make monthly payments to FLB regarding Parcel A in the amount of $2,300.00,

4. In his final remarks at the hearing, Mr. Needler orally offered to have the Debtors apply under a government program that he referred to as Approved Lender Program which he represented would guarantee 80 percent of the FLB debt upon acceptance. No evidence was offered regarding availability of the program or its sufficiency as adequate protection to FLB. The Court does not consider the proposal as a good-faith offer of adequate protection by the Debtors.

5. Under the circumstances of this case, the Court need not reach the issue of whether the property is depreciating. However, the Court notes that the values scheduled in the Debtors' Petition, filed November 30, 1984, total $420,000.00 while their evidence at the hearing indicates a total value of $396,000.00 as of February 27, 1985.

6. These valuations are based upon substantial foundation testimony of well-qualified expert witnesses who have no interest in the outcome of the proceeding. Mr. Ahlers testified regarding values asserted by the Debtors from his Disclosure Statement, which values he conceded were his own conclusions based only upon conjecture.

and regarding Parcel B in the amount of $1,500.00. The Debtors concede that they have no funds to make any payments. Accordingly, the Court must grant FLB relief from stay.

## IV.

Turning now to Norwest's motion, the Debtors have several notes outstanding with Norwest, all cross-collateralized, in the total amount of $450,468.45 as of the date of filing. Norwest claims that it is secured by second mortgages on all the Debtors' real estate (hereinbefore described), machinery and equipment, crops, and cash collateral.

As noted earlier, in response to Norwest's motion for relief from stay, the Debtors filed certain adversary proceedings challenging Norwest's secured status. Norwest offered documentary evidence and testimony supporting its secured position at the February 27 hearing. Additionally, Mr. Ahlers' testimony tended to substantiate the validity of Norwest's security interests. The Debtors offered no contrary evidence or testimony.

Furthermore, the Debtors made no argument based on any evidence at conclusion of the hearing, or thereafter by brief, that Norwest is not secured by the collateral it claims. Finally, the Debtors' schedules do not list the Norwest claim as disputed. Accordingly, for purposes of this proceeding, the Court deems Norwest to be a secured creditor with security interests in the collateral claimed.

Parcels C and D constitute the only real estate in which equity exists after application of FLB's mortages. The Court concludes for purposes of this proceeding that the value of Parcel C is $88,000.00 and the value of Parcel D is $156,000.00[7] Principal and accrued interest owing FLB as of February 27, 1985, on its mortgage covering Parcel C was $33,390.00. Interest continues to accrue thereafter at the rate of $10.50 a day. Principal and accrued interest owing FLB as of February 27, 1985, on its mortgage covering Parcel D was

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7. The Court's reasoning is the same regarding valuation of these parcels as with Parcels A and B. See Footnote No. 6.



$6,908.08. Interest continues to accrue thereafter on Parcel D at the rate of $1.04 a day.

Accordingly, as of February 27, 1985, after application of FLB's mortgage on Parcel C, equity existed for that property in the amount of $54,610.00. After application of FLB's mortgage on Parcel D, equity existed for Parcel D in the amount of $149,091.92.

Norwest's evidence places the following values on Norwest's personal property collateral: machinery and equipment—$159,825.00; and 1984 crop inventory—$114,150.00. The Debtors value the same property at $91,200.00 and $119,500.00 respectively. Mr Ahlers provided testimony regarding valuation of the machinery and equipment, candidly stating that his valuation was based on conjecture. Norwest's evidence was by expert testimony based on substantial foundation.

The Court concludes for purposes of this proceeding that the value of the Debtors' equipment and machinery subject to Norwest's security interest is $159,825.00. From this amount must be subtracted $34,000.00 representing a first lien in favor of John Deere on a combine. The Court further concludes that the value of crop inventory is $114,150.00. Existing cash collateral is $21,779.00 after application by Debtors of $2,000.00 for living expenses pursuant to the Court's February 8, 1985 Order.

Accordingly, as of the date the Petition was filed, the value of Norwest's interest in the collateral securing the Debtors' $450,468.45 obligation was:

| | |
|---|---|
| Parcel C | $ 55,544.00 |
| Parcel D | 149,184.48 |
| Machinery and Equipment | 125,825.00 |
| 1984 Crop Inventory | 144,150.00 |
| Cash Collateral | 23,799.00 |
| TOTAL | $468,482,48 |

Norwest was, therefore, fully secured on the date of filing.

However, Norwest's position has been eroded from the date of filing to February 27, 1985, by: (1) accrual of $934.00 on

FLB's mortgage on Parcel C thereby reducing equity available to Norwest to $54,610.00; (2) accrual of interest on FLB's mortgage on Parcel D thereby reducing equity available to Norwest to $149,091.92; (3) loss of $2,000.00 cash collateral pursuant to this Court's Order of February 8, 1985, reducing the cash collateral to $21,779.00; and (4) accrual of interest on the overall indebtedness post-petition in the amount of $15,615.94.[8]

The overall value of Norwest's collateral has diminished, without regard to depreciation, to $465,455.92, while interest has accrued increasing the indebtedness to $466,084.39. Norwest is presently undersecured and is entitled to periodic adequate protection payments during pendency of the case from February 27, 1985, for the same reasons applicable to FLB.[9]

The adequate protection payments required would be at least interest on the underlying value of the collateral as of the time post-petition that it became equal to the indebtedness. Accordingly, interest payments would be required on $466,084.39. The Court believes 12 percent annual interest to be a reasonable rate for adequate protection payments. The Debtors would, therefore, need to make monthly payments to Norwest in the amount of $4,660.84 from February 27, 1985.

Additionally, the Debtors would need to make monthly payments to Norwest in the amount of $346.20 to prevent further erosion of Norwest's secured position on Parcels C and D. That amount equals the monthly accrual of interest on FLB's first mortgages covering those parcels. The total monthly adequate protection payments required would be $5,700.04. The Debtors concede that they have no funds to

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8. Interest accrues at the rate of $175.46 a day. The Debtors concede that they were in default to Norwest on the date of filing.

9. The Debtors at the February 27 hearing offered Norwest adequate protection by way of a lien on their anticipated 1985 crop. However, it is clear that under the circumstances of this case the offer of a lien in a future crop does not constitute adequate protection. See: *Commodity Credit Association v. Howley (In re Howley)*, Civ. No. 3-84-792 (D. Minn. Sept. 1984); *In re Nikolaisen*, 38 B.R. 267 (Bankr. N.D. 1984); and *In re Martin, et al*, Civ. Nos. A3-84-87; A3-84-88; A3-84-89 (D. N.D. May 24, 1984)



make any payments. Accordingly, the Court must grant Norwest relief from stay.[10]

## V.

Finally, the Court now turns to the issue of retention by the Debtors' attorneys of the retainer received prepetition in the amount of $12,200.00 for services to be rendered in the case. The Debtors are without the means to sustain themselves during pendency of the case. They have no cash and there is no cash collateral reachable by them in light of their asset-to-debt ratio. The Court observed in its February 8, 1985 Order that under the circumstances of the case, it seemed inappropriate that these funds be captured and held in trust during pendency of the case merely to ensure payment of attorney's fees that might ultimately be allowed, when there was clearly a more immediate need for use of the money. Payment of the retainer was made by the Debtors' son and there is no reason to believe that the same funds would not be made available to the Debtors for their living expenses. In fact, under the circumstances of the case, these funds appear to be the only source from which the Debtors can pay their living expenses.

Rule 2017(a) provides:

> **(a) Payment or Transfer to Attorney Before Commencement of Case.** On motion by any party in interest or on the court's own initiative, the court after notice and a hearing may determine whether any payment of money or any transfer of property by the debtor, made directly or indirectly and in contemplation of the filing of a petition under the Code by or against the debtor, to an attorney for services rendered or to be rendered is excessive.

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10. Since Norwest is presently undersecured, it is entitled to adequate protection payments that the Debtors concede they cannot make, and since the Court is granting relief from stay, the Debtors' continuing request for use of cash collateral must be rejected as moot. The same is true regarding the Debtors' request for the Court's reconsideration of paragraph three in the Court's February 8, 1985 Order prohibiting further use of corn.

The Rule implements §329 of the Code which provides:

**Debtor's transactions with attorneys**

(a) Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

(b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—

(1) the estate, if the property transferred—
(A) would have been property of the estate; or
(B) was to be paid by or on behalf of the debtor under a plan under chapter 11 or 13 of this title; or

(2) the entity that made such payment.

At the hearing on February 27 regarding this issue, Mr. Needler testified at length concerning his expertise in the field of bankruptcy practice and the reasonableness of the retainer as a fee. The Court believes that Rule 2017(a) is sufficiently broad to enable the Court to find a retainer excessive without regard to whether it bears a reasonable relationship to the fee that might ultimately be allowed in the case. The Advisory Committee Note to the Rule states in pertinent part:

> Section 60d was enacted in recognition of 'the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probably failure.' [citation omitted] This rule, like §60d of the Act and §329 of the Code, is premised on the need for and appropriateness of judicial scrutiny of arrangements between a debtor and his attorney to protect the creditors of the estate and the debit against overreaching by an officer of the court who is in a peculiarly advantageous position to impose on both the creditors and his client. . . .



The reasonableness of a fee in a bankruptcy, particularly in a Chapter 11 reorganization, is dependent upon many factors and cannot be finally determined until the conclusion of the case. Any fee ultimately allowed is accorded the status of an administrative expense. In light of this and the overall purpose of the Rule, the question whether a retainer taken in a Chapter 11 case is excessive should be determined upon circusmtances of the debor and the case existing at the time the retainer is taken.

Accordingly, the Court concludes a retainer can be found to be excessive if it deprives a debtor of the use of funds needed to reorganize or to sustain himself and his family during reorganization. Such a circumstance could only be the result of either: "the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure"; or an agreement between a debtor and his attorney giving rise to the need for protection of the debtor against "overreaching by an officer of the court who is in a peculiarly advantageous position to impose on . . . his client".

In this case, the retainer paid deprived the Debtors of funds needed to pay their living expenses during pendency of the case. According to the schedules, the Debtors had $100.00 in unencumbered cash upon the filing of the petition and no funds as of the February 27, 1985 hearing. In light of the Debtors' extremely strained financial condition, the Court finds that the retainer paid on behalf of the Debtors to their attorneys in the amount of $12,200.00 was excessive.

This is without regard to whether the retainer bears a reasonable relationship in amount to attorney's fees that might be ultimately allowed the Debtors' attorneys in the case. However, under the particular circumstances of the matter, the Court feels that it is appropriate, if not necessary, for it to make some observations concerning the question of attorney's fees in this case. First, compensation of an attorney

representing a Chapter 11 debtor is subject to allowance by the Court upon notice and hearing pursuant to 11 U.S.C. §330. Thus, an attorney approved pursuant to 11 U.S.C. §327 to represent a debtor-in-possession and who receives a retainer for services to be rendered during the case, holds the retainer in trust pending proper application for allowance of fees, hearing and Order of the Court.

The fact that a retainer is paid by someone other than the debtor does not relieve an attorney from his trust obligation or the requirement for approval of attorney's fees by the Court. Apparently, the Debtors' counsel overlooked this since Mr. Needler candidly testified that he applied the retainer taken in this case to his fees as they were incurred. Based on the testimony, presumably the entire retainer has been already applied. However, there has never been a proper application brought before the Court for allowance of interim fees. Under the circumstances, application of the retainer to fees without approval and Order of the Court was improper.

Secondly, Mr. Needler's testimony regarding his extensive experience and expertise in bankruptcy matters and the obvious posture of this case reflected by the Debtors' schedules alone, provoke the Court to question why this case was filed as a Chapter 11 case. As noted earlier, the Debtors' schedules represent the Debtors' two major secured creditors as being substantially undersecured. Norwest had, prior to the filing, commenced mortgage foreclosure proceedings. Even assuming the values assigned by the Debtors to the collateral held by these creditors, it is obvious from the schedules that the Debtors would be unable to adequately protect FLB's and Norwest's positions during pendency of the case. They have no unencumbered assets, no income, and no source from which to make any adequate protection payments regardless of valuation and amount.

Furthermore, the decision in *Lend Lease v. Briggs Transportation, supra,* was issued September 26, 1984, over two months prior to the commencement of this case. That decision clearly sets forth the law in the District of Minnesota regarding the rights of undersecured creditors to adequate protection payments under circumstances such as those involved in this case. To the Court's knowledge, nothing ever existed in



connection with this case to justify any reasonable expectation that FLB and Norwest would not exercise their rights.

Accordingly, from the posture of the case as shown by the schedules, it is apparent that the Debtors' bankruptcy case never had any chance of succeeding under existing law in the District of Minnesota. Furthermore, the case does not present a situation where a party recognizes applicable law, but seeks to change it. Mr. Needler has never in the proceedings acknowledged the law in this District. In fact, as late as the February 27 hearing, he stated that he was unaware of the controlling case law in Minnesota.[11]

It is difficult, even at this point, to discern what Mr. Needler's theory of the case has been and what provided any basis for a good-faith belief that the Debtors might have been able to successfully reorganize.[12] In his motion filed February 19, 1985, for reconsideration of the Court's February 8 Order, Mr. Needler argues:

> Moreover, it is unlawful and unconstitutional to prevent the reorganization of any Debtor by recognizing liens on all property of the Debtor. To the extent that the Bankruptcy Code is interpreted to mean that a Debtor may be foreclosed from Chapter 11 reorganization because secured lenders hold liens on all of Debtors' assets (and therefore, adequate protection cannot be afforded from those assets) these interpretations are against public policy, unlawful and unconstitutional. It is the purpose of the Bankruptcy Code and in the public interest to afford all citizens a reasonable opportunity to reorganize. Creditor interests and claims, however, secured or valid at common law, are equitably subordinated to the lawful and reasonable efforts of the Debtor to reorganize. To interpret the Bankruptcy Code to mean that only Debtors with sufficient 'free assets' may reorganize or that Debtors who have no 'free assets' cannot reorganize without

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11. The Court finds that somewhat surprising since the Court cited *Lend Lease v. Briggs Transportation, supra,* in its February 8, 1985, interim Order in the case.
12. The Disclosure Statement filed February 7, 1985, is incomplete, misleading, and is premised in part on erroneous conclusions of law.

the consent of lenders, is to set up an unlawful and unreasonable class of persons, or to unreasonably exclude a class of citizens, under the Bankruptcy Code in derogation of the equal protections of Amendment V of the United States Constitution. Furthermore, Debtors assert that several states, at the founding of our nation, gave up to the federal government exclusive jurisdiction of bankruptcy matters on the condition that such bankruptcy protections be universally uniformly extended to all citizens and classes of citizens pursuant to the Constitution. To afford Chapter 11 reorganization protection only to a small class of Debtors who perchance may not have pledged all of their assets to lenders, or to only that small class of Debtors who perchance may have not pledged sufficient assets to permit their reorganization is a breach of the compact of federation between the states, reasonable and fair opportunity to reorganize having long since become a part of the irrevocable organize law of the nation.

To the extent that the argument is intelligible, it is wholly specious and without substance.

Furthermore, in light of Mr. Needler's representation to the Court regarding his expertise in bankruptcy matters, the Court regrettably must conclude that the argument is intended to impress the Debtors and justify a fee in the case rather than to set forth in good faith what can reasonably be considered a sustainable position of the Debtors.

Many farmers in this and other districts are experiencing extreme financial hardship. An increasing number of farmers face foreclosure and loss of farms that in many cases have been owned by their families for generations. The plight of many distressed farmers has resulted from a combination of circumstances, at least some of which, have been clearly beyond their control. Financial ruin many times also results in destruction of the only way of life that the farmer and his family have ever known. Consequently, the impact of foreclosure is generally serious and substantial.

The Bankruptcy Code is limited as a source of protection against liquidation under these circumstances. Unfortu-



nately, in many cases, as with this one, the financial distress is so severe as to be beyond cure under the Code's reorganization provisions. The Court recognizes that farmers in extremely distressed financial conditions are particularly vulnerable to the suggestions and impositions of others in desperate attempts to save their farms.

This Court will not condone promotion the Code as an elixir at the financial deathbed of a farmer, promising, in return for a fee, a cure for what is obviously a fatal condition.

## VI.

Based on the foregoing, it is hereby ordered:

1. The motion of Federal Land Bank of St. Paul for relief from the stay allowing it to foreclose its mortgaged on Parcels A and B herein more fully described is granted; provided, however, that the stay shall remain in effect with respect to the recovery of any deficiency that might result.

2. The motion of Norwest Bank-Worthington for relief from the stay to foreclose on its mortgaged and repossess its personal property collateral is hereby granted; provided, however, that the stay shall remain in effect with respect to any deficiency that might result.

3. The Debtors' attorneys, William L. Needler and Associates, LPD and William L. Needler, Zimmerman Kaplan & Reed and Charles Zimmerman, shall within ten days from the date of this Order refund to the person or entity from which they received payment, the retainer or any part thereof received by them in connection with this case in the total amount of $12,200.00; and said firms and attorneys shall within ten days from the date hereof file with the Court an affidavit of compliance.

Dated this 15 day of March, 1985.

BY THE COURT:
DENNIS D. O'BRIEN
U. S. Bankruptcy Judge

# United States Court of Appeals
## FOR THE EIGHTH CIRCUIT

No. 85-1915

James R. Ahlers and
Mary M. Ahlers,

Appellants,

v.

Norwest Bank of Worthington and
Federal Land Bank of St. Paul,

Appellees.

Appeal from the United States District Court for the District of Minnesota.

Filed: August 8, 1985

Before HEANEY, JOHN R. GIBSON and FAGG, Circuit Judges.

## ORDER

The debtors, James and Mary Ahlers, are the owners of 560 acres of farmland in Noble County, Minnesota. They lease approximately 280 additional acres. Most of the land is currently under cultivation with approximately one-half being planted in corn and the other half in soybeans. The crop is insured and, to this point, is progressing satisfactorily. There are no liens on this crop.

The Federal Land Bank of St. Paul, Minnesota, holds a first mortgage on all the land owned by the debtors; the Norwest Bank of Worthington, Minnesota, holds a second mortgage on a portion of the land, and has security interest in the crops in storage and in the farm equipment and machinery. The debtors are delinquent in payment of principal and interest to both the Federal Land Bank of St. Paul and Norwest Bank of Worthington.

On the 30th day of November, 1984, the debtors filed a petition under Chapter XI of the Bankruptcy Act, seeking

reorganization of its debts. Thereafter, the creditors sought to have the automatic stay lifted, and the bankruptcy judge decided in their favor, holding that both creditors are undersecured and their collateral is without adequate protection. The debtors then appealed the decision of the bankruptcy judge to the United States District Court for the District of Minnesota, and that court refused to upset the decision of the bankruptcy court but agreed to stay foreclosure of the mortgage and collection on the security interest pending the appeal to this Court. The debtors have filed a motion for stay pending appeal and, in the alternative, a petition for a writ of mandamus and exercise of supervisory authority under 28 U.S.C. § 1651 and Fed. R. App. P. 21, compelling the district court to stay proceedings pending appeal. After carefully reviewing the materials submitted in support of these motions, we note that the crops in the ground are not subject to lien and have a value sufficient to reasonably insure that neither creditor will be further harmed if foreclosure and repossession proceedings are stayed.

In light of these circumstances, we stay the Norwest Bank of Worthington from foreclosing on any mortgages of the debtors and from repossessing any equipment or machinery or other personal property subject to lien until November 15, 1985, or further order of this Court. We also stay the Federal Land Bank of St. Paul from taking any step with respect to foreclosure of the mortgage on the debtors' property until after November 15, 1985, or until further notice of this court.

To insure that both creditors are reasonably protected during the stay,

1. We create a lien on the debtors' unharvested 1985 crop in favor of the Norwest Bank of Worthington and the Federal Land Bank of St. Paul. (The debtors have heretofore consented to the establishment of this lien.) The parties shall promptly take those actions necessary to perfect the lien. The lien is only for the purpose of securing payment of interest that is determined by the district court to have accrued on the obligation of the debtors since the petition in bankruptcy was filed. *See In Re: Martin*,761 F.2d 472 (8th Cir. 1985). The lien is not to be used to secure other preexisting debt.



2. We require that the grain, currently in storage and already subject to a lien in favor of Norwest Bank of Worthington, be sold promptly and that the proceeds from the sale be placed in an interest-bearing escrow account subject to Norwest's security interest and further order of this court.

3. We require the debtors to submit promptly to the creditors, a statement detailing the cost of harvesting the 1985 crop. The debtors will permitted to withdraw from the funds in escrow an amount sufficient to pay the cost of harvesting the crop. Any sums expended for this purpose shall be repaid to the escrow account from the proceeds of the sale of the 1985 crop.

4. We require the debtors to furnish to the creditors evidence indicating that the farm equipment and machinery subject to lien are fully insured, and we further require the debtors to properly maintain that equipment during the period of the stay so that the creditors' interest will not be diminished.

From and after the date of this order, the debtors are to be allowed $1,000 per month for living expenses. This allowance will come from escrow funds, and any funds expended for this purpose are to be repaid from the sale of the 1985 crop.

The district court is requested to determine the merits of this matter, including the probability of success of the plan of reorganization, so that if the matter is to be appealed, it may be heard by this Court during the November, 1985, Term of Court.

# UNITED STATES DISTRICT COURT

DISTRICT OF MINNESOTA
THIRD DIVISION

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IN THE MATTER OF: Bankruptcy No. 3-84-2206
JAMES R. AHLERS, 3-85 CIV 873
MARY M. AHLERS,

Debtors/Appellants. ORDER
NORWEST BANK
WORTHINGTON,
FEDERAL LAND
BANK OF ST. PAUL,
Appellees.

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James R. Ahlers and Mary M. Ahlers, debtors, have appealed from the bankruptcy court's Order dated March 15, 1985, granting creditors Norwest Bank-Worthington (Norwest) and Federal Land Bank of St. Paul (FLB) relief from the automatic stay and ordering the Ahlers' attorneys to return a retainer fee received prior to commencement of the case.

## FACTS

The debtors are debtor-in-possession farmers who filed for relief under Chapter 11 of the Bankruptcy Code on November 30, 1984. According to their schedules, the Ahlers owed creditors $1,042,301.00, $955,767.00 of which was secured, when the petition was filed. The schedules reflect property owned by the Ahlers having a value of $696,499.00.

Norwest is scheduled as a secured creditor with a claim in the amount of $499,528.00, which is represented as noncontingent, liquidated and undisputed. The schedules disclose that the Ahlers' crop inventory, equipment, machinery and certain real estate mortgages secure the indebtedness to Norwest. Total value of this security is represented in the schedules to be $256,215.00. Additionally, the parties agree that the debtors had, on the date of filing, $23,799.00 cash

deposit which is Norwest's cash collateral from a prepetition sale of livestock.

FLB is scheduled as a secured creditor with a claim in the amount of $463,325.00, which is represented as nonconting-ent, liquididated and disputed. The schedules disclose that first mortgages on all Ahlers' real estate, represented as having a total value of $420,000.00, secure the indebtedness to FLB.

A hearing was held before the bankruptcy court on February 7, 1985, regarding Norwest's motion for relief from the automatic stay. No testimony was taken at this hearing due to the absenes of Norwest's witness, who was expected to testify on the valuation issue. The court continued the hearing on Norwest's request for relief from the stay to February 27, 1985, for final hearing. On February 8, 1985, the court issued an interim Order: (1) requiring that the debtors make, on or before February 20, 1985, an adequate protection payment to Norwest in the amount of $1,795.00; (2) enjoining the debtors from further use of corn in which Norwest claims a security interest, without payment to Norwest in advance at the rate of $2.30 per bushel for corn to be used; and (3) allowing the debtors use of Norwest's cash collateral in the limited amount of $2,000.00 for living expenses. As of February 27, 1985, the debtors had not made the adequate protection payment of $1,795.00. FLB had also filed its motion for relief from stay.

On February 27, 1985, a complete evidentiary hearing was held on the pending motions for relief from stay brought by Norwest and FLB. The court also heard debtors' motion for reconsideration of its February 8th Order. Based upon the testimony presented at the February 27, 1985, hearing and the submissions of the parties, the bankruptcy court made a number of findings and issued its March 15 Order accordingly.

First, the court found FLB substantially undersecured with respect to two parcels of real estate, referred to in the court's Order as Parcels A and B. Furthermore, the debtors were found to be in serious default on both underlying notes. In order to adequately protect FLB's interest in Parcels A and B, the debtors would have to make monthly payments to FLB in the total amount of $3,800.00. The debtors concede they have



no funds to make any payments. Accordingly, the court granted FLB relief from the automatic stay.

Second, the bankruptcy court found that the real estate, machinery, equipment, crop inventory, and cash collateral in which Norwest claimed a security interest is not of sufficient value to secure the Ahlers' underlying obligation to Norwest Bank. Moreover, the Bankruptcy Court found that Norwest's position has and continues to erode due to: (1) accrual of interest on FLB's first mortgage on the real estate, which reduces the equity available to Norwest; (2) loss of $2,000.00 cash collateral pursuant to the bankruptcy court's Order of February 8, 1985; and (3) accrual of interest on the overall indebtedness to Norwest. The debtors concede that they were in default to Norwest at on the date of filing. The court further found that monthly adequate protection payments of $5,007.04 would be required to protect Norwest's interest in the collateral. Again, the debtors have no funds to make any payments. Accordingly, the bankruptcy court granted Norwest relief from the stay.

Finally, the bankruptcy court concluded that the $12,200.00 retainer paid by the debtors' son to debtors' attorneys is excessive because payment of the retainer deprived the debtors of funds needed to pay their living expenses during pendancy of the case. The court made this finding without regard to whether the retainer bore a reasonable relationship in amount of attorneys' fees that might ultimately be allowed the debtors' attorneys in this case. The court then made three observations it considered appropriate, if not necessary, under the particular circumstances of the matter.

First, debtors' counsel applies the retainer taken in this case to his fees as they were incurred, without regard to 11 U.S.C. §§ 329, 330 (1982), which together require debtors' attorneys to submit to the bankruptcy court, for its approval, a statement of the compensation paid or agreed to be paid. Under the circumstances, the court considered application of the retainer fees without approval and order of the court improper. Second, the court noted the debtors had no unencumbered assets, no income, and no source from which to make any adequate protection payments regardless of valua-

tion and amount. Therefore, the court questioned the judgment of debtors' counsel in filing this action under Chapter 11, particularly in light of debtors' counsel's professed experience and expertise in bankruptcy matters. Finally, the court criticized debtors' counsel for failing to discover this court's decision in *Lend Lease v. Briggs Transportation*, CIV 3-84-224 (D.Minn. Sept. 26, 1984), *rev'g* 35 Bankr. 210 (Bankr. D.Minn. 1984). As a result of this omission, debtors' counsel consistently took a position contrary to existing law in the District of Minnesota. Has debtors' counsel correctly understood the existing law in this district, the court observed, counsel would have recognized that the debtors' bankruptcy case never had a reasonable prospect of succeeding under Chapter 11.

For these reasons, the bankruptcy court ordered debtors' counsel to return its retainer fee to the debtors' son. In an Order dated June 19, 1985, the bankruptcy court awarded debtors' counsel the sum of $5,000.00 as and for fees and expenses incurred through March 31, 1985, without prejudice to counsel in applying for an additional award for the same period upon resolution of the issues on appeal from the court's March 15, 1985, Order. The court authorized, but did not direct, the debtors' son to pay the fees and expenses allowed in its June 19, 1985, Order on behalf of the debtors' estate. The court further allowed the son an administrative expense claim to the extent of any payment made by him.

On July, 1985, this court denied debtors' motion to stay the bankruptcy court's Order of March 15, as amended on March 26, pending appeal. On August 8, 1985, the Eighth Circuit Court of Appeals stayed FLB and Norwest from foreclosing on any mortgages of the debtors or repossessing any equipment, machinery, or other personal property until after November 15, 1985, or further order of the Court of Appeals.

## STANDARD OF REVIEW

The bankruptcy court's findings of fact are not to be overturned unless clearly erroneous; however, its conclusions of law are subject to *de novo* review. *In re: Martin*, 761 F.2d 472, 474 (8th Cir. 1985); *In re: Comer*, 723 F.2d 737, 739 (9th Cir. 1984). The Eighth Circuit considers the issue of adequate



protection a question of fact. *In re: Martin*, 761 F.2d at 474. Nevertheless, this court has the power to correct errors of law, including "a finding of fact that is predicated on a misunderstanding of the governing rule of law." *Bose Corporarion v. Consumer Union of United States*, U.S. 104 S.Ct. 1949, 1960 (1984); *In re: Martin*, 761 F.2d at 475.

## DISCUSSION

Debtors' appeal presents five issues for this court's consideration. First, did the bankruptcy court apply the correct standard in determining whether the Ahlers are able to provide FLB and Norwest adequate protection? Second, was the bankruptcy court's finding that the Ahlers are not able to offer adequate protection of the banks' interest in the collateral clearly erroneous? Third, does debtors' plan for reorganization have a reasonable likelihood of success? Fourth, did the bankruptcy court correctly refuse to permit the debtors to use Norwest's cash collateral for living expenses? Finally, was the bankruptcy court justified in limiting compensation to debtors' counsel to $5,000.00? This court has reviewed the memoranda and exhibits submitted by the parties and the transcript of the hearing before the bankruptcy court held February 27, 1985. Because the foregoing issues were presented in these materials, the court deemed oral argument unnecessary.

### 1. Standard Applied

The bankruptcy court concluded that an undersecured creditor is entitled to compensation as adequate protection for the delay in enforcing contractual repossession and foreclosure rights during the interim between filing of the petition and confirmation of a plan. It is the present value of that interest, the opportunity lost, that must be protected. *In re: Ahlers*, BKY 3-84-2206, slip op. at 5 (Bankr. Minn. March 15, 1985), *as amended* March 26, 1985. Absent some other reasonable and appropriate offer of adequate protection, the court concluded, the debtors would be required to make periodic payments to FLB and Norwest equal to the interest

on the underlying value of the collateral in order to maintain the section 362 stay. *Id.* at 6.

The standard by which the bankruptcy court judged the debtors; offer of adequate protection is an accurate recitation of the *American Mariner* interpretation of section 361's indubitable equivalent standard. *See* 11 U.S.C. § 361(3) (1982); *Crocker National Bank v. American Mariner Industries, Inc.*, 734 F.2d 426, 435 (9th Cir. 1984); *see also Ir re: Murel Holding Corporation*, 75 F.2d 941 (2nd Cir. 1935) (source of "indubitable equivalent" standard). The *American Mariner* interpretation is the law of this jurisdiction. *In re: Martin*, 761 F.2d at 475-76. It was also the law of this jurisdiction when the debtors filed their petition. *Lend Lease*, CIV 4-84-224, slip op. at 3.

## 2. Offers of Adequate Protection

Whether the debtors' offer constituted adequate protection under the *American Mariner* standard is a question of fact. *In re: Martin*, 761 F.2d at 474. Thus the bankruptcy court's order is not to be overturned unless a review of the record leaves this court with a definite or firm conviction that a mistake has been committed. *United Properties, Inc. v. Emporium Dep't Stores, Inc.*, 379 F.2d 55, 64 (8th Cir. 1967).

### a. To FLB

Based upon testimony presented at the February 27 hearing, Tr. 55, the court concluded that the value as of February 27 of Parcels A and B were $230,000.00 and $150,000.00, respectively. From these figures, the court calculated that the monthly payments required to adequately protect FLB regarding Parcel A would be $2,300.00, and regarding Parcel B $1,500.00. The bankruptcy court found that the debtors failed to make an offer to FLB of adequate protection. The only proposal made by debtors occured during their counsel's final remarks at the February 27 hearing when Mr. Needler orally offered to have the debtor apply under a government program that he referred to as the Approved Lender Program. Mr. Needler offered no evidence regarding availibility of the program or its sufficiency as adequate protection to FLB. The court did not consider the



proposal a good faith offer of adequate protection by the debtors.

Absent a good faith offer to provide such protection, the bankruptcy court's conclusion that debtors are unable to offer FLB adequate protection is not clearly erroneous.

### b. To Norwest

The bankruptcy court found that the value of Norwest's collateral on February 27, 1985, was $465,455.92[1]. The court further found that the value of Norwest's interest in the collateral securing the debtors' obligation continues to drop at a rate of $11.54 per day even without regard to depreciation, due to the amount of interest accruing on FLB's first mortgages on Parcel C and D.

The bankruptcy court also found that the Ahlers' indebtedness to Norwest on February 27 was $466,084.39. This indebtedness is increasing as interest accrues at the rate of $175.46 per day. Therefore, the court concluded, Norwest is presently undersecured and is entitled to periodic adequate protection payments during the pendency of the case from February 27, 1985.

Next, the court found that the adequate protection payments required would at least be equal to 12 percent annual interest on the underlying value of the collateral as of the time it became equal to the indebtedness. This finding would require debtors to make monthly payments to Norwest in the amount of $4,660.84 from February 27, 1985. Additionally, debtors would have to make monthly payments to Norwest in the amount of $346.20 to prevent further erosion of Norwest's secured position in Parcels C and D. That amount equals the monthly accrual of interest on FLB's first mortgage on those parcels. Thus the total monthly adequate protection payment required would be $5,007.04.

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1. Although the transcript of the February 27 hearing indicates that Norwest's witness, Arden Harberts, testified that the total value of Parcel B was $136,000.00, a recalculation based upon his testimony as to the price per acre of land in that Parcel produces a figure of $156,000.00. The latter value is the figure the Bankruptcy Court used in calculating the value of collateral available to secure Norwest's mortgage.

Finally, the debtors conceded that they have no funds to make any payments. The court rejected the debtors offer of a lien in their anticipated 1985 crop as inadequate, citing this court's opinion in *Commodity Credit Association v. Howley (In re: Howley),* CIV 3-84-792 (D.Minn. Sept. 27, 1984) (noting that federal crop insuranse will not protect a creditor completely against risks to value of a future crop). Accordingly, the court granted Norwest relief from the stay. This court cannot hold that the court's factual findings are clearly erroneous.

### 3. Likelihood of Successful Reorganization

In its order of August 8, the Court of Appeals requested this court to determine the feasibility of the debtors' plan of reorganization. In determining whether the plan is feasible, this court must scrutinize the plan carefully to determine whether it offers a reasonable prospect of success and is workable. *In re: Monnier Bros.,* 755 F.2d 1336, 1341 (8th Cir. 1985); *United Properties, Inc. v. Emporium Dept. Stores, Inc.,* 379 F.2d 55, 64 (8th Cir. 1967); *see* 5 *Collier on Bankruptcy* paragraph 1129.02 at 1129-33 (15th ed. 1984). This court is not bound to clog its docket with visionary or impracticable schemes for resusicitation. *Tennesses Publishing Co. v. American National Bank,* 299 U.S. 18, 22 (1936); *see In re: Monnier Bros.,* 755 F.2d at 1341. The following factors determine the feasibility of a debtors' plan: (1) ratio of current assets to current liabilities; (2) the debtors' solvency; (3) evidence demonstrating that the debtor could operate at a profit; (4) debtor's cash flow; (5) capability of debtor's management; and (6) economic conditions affecting debtor's situation. *United Properties,* 379 F.2d at 66-71.

Analysis of debtors' proposed plan in light of these considerations reveals the plan's utter unfeasibility. The court presumes the debtors are capable farmers and managers, despite their present difficulties. All their other circumstances, however, militate strongly against success.

In *United Properties*, the Eighth Circuit reversed the district court's conclusion that the debtors had a reasonable chance of success under the Plan of Arrangement confirmed by the Referee. 379 F.2d at 65. The Court of Appeals based



this decision in part upon a finding that the debtors asset to liability ratio was 1.34 to 1 at the time of filing, and had since declined to .98 to 1. In the instant case, debtors' schedules reflect a ratio of .67 to 1.[2] In addition, this negative ratio renders debtors insolvent by a substantial margin.

Debtors also have failed to establish their ability to operate profitably in the future. Indeed, debtors have suffered large losses in recent years. Tr. 139. Debtors have no significant cash flow. T. 144. Finally, the oppressive economic conditions confronting American farmers are unlikely to improve soon, and any political assistance will be too little and too late to redeem circumstances as dire as debtors'. Therefore, debtors stand little chance of reorganizing successfully, even without regard to the monthly adequate protection payments required under section 361.

As a related matter, the Eighth Circuit requested that this court determine the interest that has accrued to date upon debtors' obligation to FLB and Norwest. The bankruptcy court found the principal owing on debtors' four mortgages to FLB as of November 30, 1984, was $525,854.63. At a rate of 12% simple interest, the interest due on this amount as of October 15, 1985, was $55,214.73. The court also found that the value of debtors' obligations to Norwest on November 30, 1984, was $450,468.45. The interest accruing on this amount as of October 15, 1985, was $47,299.19.

### 4. Use of Cash Collateral

Debtors challenge the bankruptcy court's decision denying them use of cash for their living expenses. Debtors contend that use of the cash collateral is needed to protect the remaining collateral. *See* 11 U.S.C. § 506(c) (1982). Because this court affirms the bankruptcy court's decision to lift the automatic stay, the creditors are free to protect the collateral themselves. Accordingly, debtors' challenge remains moot.

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2. Debtors list liabilities of $1,042,301.00 and assets of $696,499.00.

## 5. Order to Return Retainer

Finally, the debtors challenge the court's decision to order their attorneys to return the $12,200.00 prepetition retainer provided by the debtor's son. The court made this order pursuant to Bankruptcy Rule 2017(a). That rule implements section 329 of Title 11 which provides:

> (a) Any attorney representing a debtor in a case under this title [11 USCS §101 et seq.], or in connection with such a case, whether or not such attorney applies for compensation under this title [11 USCS §§101 et seq.], shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.
>
> (b) If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to—
>
> (1) the estate, if the property transferred—
>
> (A) would have been property of the estate; or
>
> (B) was to be paid by or on behalf of the debtor under a plan under Chapter 11 or 13 of this title [11 USCS §§1101 et seq., 1301 et seq.]; or
>
> (2) the entity that made such payment.

11 U.S.C. §329 (1982).

The court found the retainer excessive without regard to whether it bore a reasonable relationship to the fee that might ultimately be allowed in the case. The court noted that the debtors are without means to sustain themselves during pendency of the case, and suggested that the return of the retainer to the debtors' son would make the funds available for this purpose. Considering these circumstances and the evident purpose of section 329 to "protect the creditors of the estate and the debtor against overreaching by officer of the



court. . . ," *See* Advisory Committee Note to Rule 2017, the court found the retainer excessive.

Section 329 appears to require that excessiveness of an attorney's compensation be determined by comparison of the compensation to the reasonable value of services rendered by the attorney in connection with the case. 11 U.S.C. §329 (1982). Thus the Code does not appear on its face to authorize a determination that a retainer is excessive "without regard to whether it bears a reasonable relationship to the fee that might ultimately be allowed in the case." However, this court need not reach the issue of whether such a finding nevertheless is consistent with the Code's purpose, because the bankruptcy court made several factual observations that adequately support a finding of excessiveness under section 329.

The bankruptcy court justifiably questioned why this case was filed as a Chapter 11 case. It noted:

> "Even assuming the values assigned by the debtors to the collateral held by these creditors, it is obvious from the schedules that the Debtors would be unable to adequately protect FLB's and Norwest's positons during pendency of the case. They have no unencumbered assets, no income, and no source from which to make any adequate protection payments regardless of valuation and amount."

*In re: Ahlers*, slip op. at 13. Moreover, had debtors' counsel been familiar with the existing law in the District of Minnesota following this court's decision in *Lend Lease*, it would have been apparent to them that this case could not succeed as a Chapter 11 case. Therefore, the benefit conferred upon the debtors by instituting this action in Chapter 11 was minimal. *See In re: Meyers*, 4 Bankr. 343 (Bankr. M.D. Fla. 1980) (minimal benefit of services may justify forfeiture of attorney's fees). Furthermore, the bankruptcy court pointed out that counsel's argument in support of his clients, although verbose, is largely insubstantial. With regard to all of these criticisms, this court is of a similar mind.

Based upon the foregoing,

IT IS ORDERED That the bankruptcy court's Orders dated March 15, 1985, as amended on March 26, 1985, and June 17, 1985 be and hereby are affirmed.

DATED: October 22, 1985.

DONALD D. ALSOP
United States Distribt Judge

## § 361. Adequate protection

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

## § 362. Automatic stay

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), does not operate as a stay—

(1) under subsection (a) of this section, of the commencement or continuation of a criminal action or proceeding against the debtor;

(2) under subsection (a) of this section, of the collection of alimony, maintenance, or support from property that is not property of the estate;

(3) under subsection (a) of this section, of any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of this title;

(4) under subsection (a)(1) of this section, of the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;

(5) under subsection (a)(2) of this section, of the enforcement of a judgment, other than a money judgment, obtained in an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power;



(6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker financial institution,, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761(4) of this title, forward contracts, or securities contracts, as defined in section 741(7) of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker financial institution,, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts;

(7) under subsection (a) of this section, of the setoff by a repo participant, of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, arising out of repurchase agreements against cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements;

(8) under subsection (a) of this section, of the commencement of any action by the Secretary of Housing and Urban Development to foreclose a mortgage or deed of trust in any case in which the mortgage or deed of trust held by the Secretary is insured or was formerly insured under the National Housing Act and covers property, or combinations of property, consisting of five or more living units;

(9) under subsection (a) of this section, of the issuance to the debtor by a governmental unit of a notice of tax deficiency; or

(10) under subsection (a) of this section, of any act by a lessor to the debtor under a lease of nonresidential real

property that has terminated by the expiration of the stated term of the lease before the commencement of or during a case under this title to obtain possession of such property.

(11) under subsection (a) of this section, of the presentment of a negotiable instrument and the giving of notice of and protesting dishonor of such an instrument.

(c) Except as provided in subsections (d), (e), and (f) of this section—

(1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate; and

(2) the stay of any other act under subsection (a) of this section continues until the earliest of—

(A) the time the case is closed;

(B) the time the case is dismissed; or

(C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, or 13 of this title, the time a discharge is granted or denied.

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

(e) Thirty days after a request under subsection (d) of this section for relief from the stay of any act against property of the estate under subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the court, after notice and a hearing, orders



such stay continued in effect pending the conclusion of, or as a result of, a final hearing and determination under subsection (d) of this section. A hearing under this subsection may be a preliminary hearing, or may be consolidated with the final hearing under subsection (d) of this section. The court shall order such stay continued in effect pending the conclusion of the final hearing under subsection (d) of this section if there is a reasonable likelihood that the party opposing relief from such stay will prevail at the conclusion of such final hearing. If the hearing under this subsection is a preliminary hearing, then such final hearing shall be commenced not later than thirty days after the conclusion of such preliminary hearing.

(f) Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section.

(g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section—

(1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and

(2) the party opposing such relief has the burden of proof on all other issues.

(h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

## § 1129. Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this title.

(2) The proponent of the plan complies with the applicable provisions of this title.

(3) The plan has been proposed in good faith and not by any means forbidden by law.

(4) Any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable;

(5)(A)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy; and

(B) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

(6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

(7) With respect to of[1] each impaired class of claims or interests—

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class



will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

(8) With respect to each class of claims or interests—

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

(A) with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim;

(B) with respect to a class of claims of a kind specified in section 507(a)(3), 507(a)(4), or 507(a)(5) of this title, each holder of a claim of such class will receive—

(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim; and

(C) with respect to a claim of a kind specified in section 507(a)(6) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor

to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or



(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a class of interests—

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

(c) Notwithstanding subsections (a) and (b) of this section and except as provided in section 1127(b) of this title, the court may confirm only one plan, unless the order of confirmation in the case has been revoked under section 1144 of this title. If the requirements of subsections (a) and (b) of this section are met with respect to more than one plan, the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm.

(d) Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application section 5 of the Securities Act of 1933 (15 U.S.C. 77e). In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.

## § 46. Assignment of judges; panels; hearings; quorum

(c) Cases and controversies shall be heard and determined by a court or panel of not more than three judges (except that the United States Court of Appeals for the Federal Circuit may sit in panels of more than three judges if its rules so

provide), unless a hearing or rehearing before the court in banc is ordered by a majority of the circuit judges of the circuit who are in regular active service. A court in banc shall consist of all circuit judges in regular active service, or such number of judges as may be prescribed in accordance with section 6 of Public Law 95-486 (92 Stat. 1633), except that any senior circuit judge of the circuit shall be eligible to participate, at his election and upon designation and assignment pursuant to section 294(c) of this title and the rules of the circuit, as a member of an in banc court reviewing a decision of a panel of which such judge was a member.

## RULE 16. HEARING AND REHEARING OF CASE EN BANC

(a) How Ordered: Panel for Hearing or Rehearing. A majority of the judges of this Court in regular active service may order a hearing or rehearing en banc upon request by a party, a judge of this Court in regular active service, or, in the case of a rehearing en banc, upon request by a judge who was a member of the panel that rendered the decision sought to be reheard. The panel for the hearing or rehearing consists of the judges of this Court in regular active service who are actively participating in the affairs of the Court at the time of the hearing or rehearing and who are not disqualified in the particular case or controversy. Upon a rehearing en banc, however, a senior circuit judge shall be eligible at his election to participate on the en banc court in reviewing a decision of a panel of which such judge was a member. If a judge on his own motion wishes to request a rehearing en banc, he must do so within the time fixed for a similar request by party.

(b) Number of Petitions Filed. 12 copies of every petition requesting or suggesting hearing or rehearing en banc shall be filed. The petition shall be complete in itself and may not refer to or adopt by reference any matter from other briefs or motions in the case.

## Rule 28.1
## Statement of Affiliates of

Norwest Bank Worthington

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Norwest Bank Worthington is a subsidiary of Norwest Corporation. Norwest Corporation is the parent corporation of the following banks and business corporations:

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### MINNESOTA:

### Twin Cities

Norwest Bank Minneapolis, N.A.
  Norwest Investment Services, Inc.
  Norwest Bank International, Miami
  Norwest Trust Company, New York
    (a limited Purpose Trust Company)
  Minneapolis Asset Management, Inc.
  Norwest Bank International Norwest Asia Limited

Norwest Bank Midland, N.A.
  Midbank Realty Company
  Cove, Inc.
Norwest Bank Camden, N.A.
Norwest Bank Central, N.A.
Norwest Bank University-Midway, N.A.
Norwest Bank Old St. Anthony, N.A.
Norwest Bank Calhoun-Isles, N.A.
Norwest Bank MetroSouth, N.A.
Norwest Bank St. Paul, N.A.
  St. Paul Asset Management, Inc.
Norwest Bank East St. Paul
Norwest Bank South St. Paul, N.A.
Norwest Bank Bloomington, N.A.
  Bloomington Asset Management, Inc.
Norwest Bank MetroWest, N.A.
Norwest Bank Maple Grove, N.A.

### Other Minnesota Banks

Norwest Bank Albert Lea, N.A.
Norwest Bank Austin

Norwest Bank Dawson
Norwest Bank Dodge Center
Norwest Bank Duluth, N.A.
Norwest Bank Ely, N.A.
Norwest Bank Faribault, N.A.
Norwest Bank Fergus Falls, N.A.
Norwest Bank Grand Rapids, N.A.
Norwest Bank Hastings, N.A.
Norwest Bank Jordan, N.A.
Norwest Bank Litchfield, N.A.
Norwest Bank Luverne
Norwest Bank Mankato, N.A.
Norwest Bank Marshall, N.A.
Norwest Bank Mesabi, N.A.
Norwest Bank Montevideo
Norwest Bank Moorhead, N.A.
Norwest Bank Northfield
Norwest Bank Ortonville
Norwest Bank Owatonna, N.A.
Norwest Bank Red Wing, N.A.
Norwest Bank Redwood Falls, N.A.
Norwest Bank Rochester, N.A.
Norwest Bank St. Cloud, N.A.
Norwest Bank Sauk Rapids, N.A.
Norwest Bank Slayton
Norwest Bank Stillwater, N.A.
Norwest Bank Thief River Falls, N.A.
Norwest Bank Tracy
Norwest Bank Two Harbors, N.A.
Norwest Bank Winona, N.A.
Norwest Bank Worthington

## IOWA

Norwest Bank Atlantic, N.A.
Bettendorf Bank, N.A.
  NOW Club, Inc.
Norwest Bank Cedar Falls, N.A.
Norwest Bank Denison, N.A.



Norwest Bank Des Moines, N.A.
  Norwest Card Services, Inc.
  Des Moines Holding Company
Norwest Bank Fort Dodge, N.A.
Norwest Bank Keokuk, N.A.
Norwest Bank Marion, N.A.
Norwest Bank Mason City, N.A.
Norwest Bank Ottumwa, N.A.
Norwest Bank Sioux City, N.A.

## MONTANA

Norwest Bank Anaconda-Butte, N.A.
Norwest Bank Billings, N.A.
  Buffam, Inc.
Norwest Bank Dillon, N.A.
Norwest Bank Great Falls, N.A.
Norwest Bank Helena, N.A.
Norwest Bank Kalispell, N.A.
Norwest Bank Lewiston, N.A.

## NEBRASKA

Norwest Bank Nebraska, N.A.
  Nebraska Asset Management, Inc.

## NORTH DAKOTA

Norwest Bank Bismarck, N.A.
Norwest Bank Fargo, N.A.
Norwest Bank Grafton, N.A.
Norwest Bank Hillsboro, N.A.
Norwest Bank Jamestown, N.A.
Norwest Bank Mandan, N.A.
Norwest Bank Minot, N.A.
Norwest Bank Valley City, N.A.
Norwest Bank Wahpeton, N.A.

## SOUTH DAKOTA

Norwest Bank South Dakota, N.A.
  South Dakota Asset Management, Inc.

## WISCONSIN

Norwest Bank LaCrosse, N.A.

## TRUST COMPANIES

Norwest Capital Management & Trust Co., Arizona
Norwest Capital Management & Trust Co., Montana
Norwest Capital Management & Trust Co., North Dakota
Norwest Capital Management & Trust Co., South Dakota

## OTHER COMPANIES

KCH, Inc
  Norwest Mortgage Conventional Housing, Inc.
  Norwest Modern Home Capital, Inc.
    Norwest Mortgage Manufactured Housing 1, Inc.
    FRD Capital Corporation
  Norwest Multifamily, Inc.
Norwest Agricultural Credit, Inc.
Norwest Alliance System, Inc.
Norwest Audit Services, Inc.
Norwest Capital Markets, Inc.
    Norwest Brokerage Services, Inc.
    Peregrine Capital Management, Inc.
Norwest Equity Capital, Inc.
Norwest Growth Fund, Inc. (SBIC)
Norwest Information Services, Inc.
Norwest Investment Management, Inc.
Norwest Investment Advisors, Inc. (inactive)
Norwest Investors, Inc.
  Norwest V.C. Partners (25% owned)
Norwest Mortgage, Inc. (fka Norwest Funding, Inc.)
  Norwest Mortgage Insured 1, Inc.
  Norwest Mortgage Insured 2, Inc.
  Norwest Mortgage Conventional 1, Inc.
  Norwest Mortgage Wisconsin, Inc.
Norwest Overseas Finance Corporation
  Norwest Overseas Capital Corporation, N.V.
Northern Prairie Indemnity Limited
Norwest Properties, Inc.



Norwest Bank Building Company
Northerly Centre Corporation
Fourth Street Properties (50% joint venture)
Norwest Properties Holding Company
  Norwest Center, Inc.
Norwest Venture Capital Management, Inc.
Norwest Financial Services, Inc.
  Norwest Financial, Inc.
    Norwest Financial Iowa 1, Inc.
    Norwest Agencies, Inc.
    Norwest Financial Alabama, Inc.
    Norwest Financial Alaska, Inc.
    Norwest Financial Arizona, Inc.
    Norwest Financial California, Inc.
    Norwest Financial Escrow System California, Inc.
    Norwest Financial Colorado, Inc.
    Norwest Financial Connecticut, Inc.
    Norwest Financial Connecticut 1, Inc.
    Norwest Financial Delaware, Inc.
    Norwest Financial Florida, Inc.
    Norwest Financial Credit Services, Inc.
    Norwest Lease Finance, Inc.
    Norwest Financial Georgia, Inc.
    Norwest Financial Hawaii, Inc.
    Norwest Financial Idaho, Inc.
    Norwest Financial Illinois, Inc.
    Norwest Financial Indiana, Inc.
    Norwest Financial Business Credit, Inc.
    Norwest Financial Iowa 2, Inc.
    Norwest Financial Leasing, Inc.
    Ellis Advertising, Inc.
    Norwest Financial Leasing Iowa, Inc.
    Norwest Financial Leasing Des Moines, Inc.
    Centurion Casualty Company
    Mail Systems Co.
    Norwest Financial Kansas, Inc.
    Norwest Financial Kentucky, Inc.
    Norwest Financial Kentucky 1, Inc.
    Norwest Financial Louisiana, Inc.
    Norwest Financial Maryland, Inc.

Norwest Financial Maryland 1, Inc.
Norwest Financial Massachusetts
Norwest Financial Massachusetts 1
Norwest Business Credit, Inc.
Norwest Financial Minnesota, Inc.
Norwest Financial System Minnesota, Inc.
Norwest Leasing, Inc.
Norwest Financial Mississippi, Inc.
Norwest Financial Missouri, Inc.
Norwest Financial Missouri 1, Inc.
Centurion Life Insurance Company
Norwest Agencies Montana, Inc.
Norwest Financial Montana, Inc.
Norwest Financial Nebraska, Inc.
Norwest Financial Nebraska 1, Inc.
Norwest Financial Nevada, Inc.
Norwest Financial Nevada 1, Inc.
Norwest Financial Nevada 2, Inc.
Norwest Financial New Jersey, Inc.
Norwest Financial New Mexico, Inc.
Norwest Financial New Mexico 1, Inc.
Norwest Financial North Carolina, Inc.
Norwest Financial North Carolina 1, Inc.
Norwest Financial North Dakota, Inc.
Norwest Financial Ohio, Inc.
Norwest Financial Ohio 1, Inc.
Dial Finance Company of Ohio No. 1, Inc.
Norwest Financial Ohio 2, Inc.
Norwest Financial Oklahoma, Inc.
Norwest Financial System Oregon, Inc.
Norwest Financial Consumer Discount Company
Norwest Financial America, Inc.
Norwest Financial Rhode Island, Inc.
Norwest Financial South Carolina, Inc.
Norwest Financial Credit Card Services, Inc.
Norwest Financial South Dakota, Inc.
Norwest Financial Tennessee, Inc.
Norwest Financial Texas, Inc.
Norwest Financial Utah, Inc.
Norwest Financial System Virginia, Inc.



Dial Finance Company of Washington
Norwest Financial Washington, Inc.
Norwest Financial Industrial Loan Company
Norwest Financial West Virginia, Inc.
Norwest Financial Industrial West Virginia, Inc.
Norwest Financial Wisconsin, Inc.
Norwest Financial Wyoming, Inc.

## STATEMENT OF AFFILIATES OF THE FEDERAL LAND BANK OF ST. PAUL PURSUANT TO RULE 28.1 OF THE SUPREME COURT RULES

The Federal Land Bank of St. Paul is a federal instrumentality chartered by Farm Credit Administration pursuant to the Farm Credit Act and specifically, 12 U.S.C. §2011. The Federal Land Bank of St. Paul is one of twelve (12) Federal Land Bank districts. The twelve Federal Land Bank districts make long-term loans secured by first mortgages on farm and rural real estate. The twelve Federal Land Bank districts, including their name and number and the States which are included in such districts are as follows:

1. District No. 1 - The Federal Land Bank of Springfield including the States of Massachusetts, Maine, Vermont, New Hampshire, New York, Connecticut, Rhode Island and New Jersey

2. District No. 2 - The Federal Land Bank of Baltimore including the States of Maryland, Pennsylvania, West Virginia, Delaware, Virginia and also Puerto Rico.

3. District No. 3 - The Federal Land Bank of Columbia including the States of North Carolina, South Carolina, Georgia and Florida.

4. District No. 4 - The Federal Land Bank of Louisville including the States of Kentucky, Indiana, Ohio and Tennessee.

5. District No. 5 - The Federal Land Bank of Jackson including the States of Mississippi, Alabama and Louisiana.

6. District No. 6 - The Federal Land Bank of St. Louis including the States of Missouri, Illinois and Arkansas.

7. District No. 7 - The Federal Land Bank of St. Paul including the States of Minnesota, North Dakota and Wisconsin.

8 District No. 8 - The Federal Land Bank of Omaha including the States of Nebraska, Iowa, South Dakota and Wyoming.

9. District No. 9 - The Federal Land Bank of Wichita including the States of Kansas, Colorado, New Mexico and Oklahoma.

10. District No. 10 - The Federal Land Bank of Texas (Austin) including the State of Texas.

11. District No. 11 - The Federal Land Bank of Sacramento including the States of California, Nevada, Utah, Arizona and Hawaii.

12. District No. 12 - The Federal Land Bank of Spokane including the States of Washington, Alaska, Oregon and Idaho.

Loans made by the twelve Federal Land Bank districts are administered by approximately 300 Federal Land Bank Associations (one of which is the Federal Land Bank Association of Worthington). The Federal Land Bank Association of Worthington was responsible for administering the loan to the Respondents. The Federal Land Bank Associations are owned by their member-borrowers.

Also a part of the Farm Credit System and affiliated with the Federal Land Bank districts are the twelve Federal Intermediate Credit Banks. The intermediate credit banks provide short and intermediate term loan funds to approximately 200 Production Credit Associations. The states included in each of the twelve Federal Intermediate Credit Banks correspond to the Federal Land Bank districts which are described above.

Also a part of the Farm Credit System and affiliated with the Federal Land Bank of St. Paul are the twelve district Banks for Cooperatives. These banks make loans to agricultural, aquatic and public utility cooperatives within their respective territories. The respective territories of the Banks for Cooperatives correspond to the territories for the Federal Land Bank districts described above.

# OPPOSITION BRIEF

EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

Supreme Court, U.S.
FILED
JAN 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-958

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

NORWEST BANK WORTHINGTON and
FEDERAL LAND BANK OF ST. PAUL,

Petitioners,

v.

JAMES R. AHLERS and
MARY M. AHLERS.

Respondents.

# RESPONSE TO JOINT PETITION FOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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OCTOBER TERM, 1986

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Respondents.

RESPONSE TO JOINT PETITION FOR
A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHT CIRCUIT COURT

Objections to Questions Presented

In order to gain entry to this Court, petitioners distort the holdings of the Eighth Circuit Court of Appeals in this case in their Questions Presented at page i of their petition:

1. The Circuit Court of Appeals in its proposed plan for The Ahlers has provided the following as an illustration of how its holdings should be put into effect:

> Thus under this plan, the secured creditors would be paid 100% of their allowed secured claims, with interest, and 100% of their unsecured claims, without interest, and the Ahlers would remain on their farm. If liquidated, the creditors would receive less than 100% of allowed secured claims (after exemption were deducted), none of their unsecured claims, and the Ahlers would be deprived of the opportunity to work on their farms. (A. 47)[1]

It is thus untrue as suggested by Petitioner that the Eighth Circuit has transgressed Section 1129 of the Bankruptcy Code and this Courts' decision in Case v. Los Angeles Lumber Products Co, 308 U.S. 106 (1939). Nor is it true under the Proposed Plan for the Ahlers that their only contribution would be a "non-cash promise to provide future labor, experience and expertise.

Present and future crops, their value and proceeds are also contributed to the proposed Ahlers plan of reorganization. (A.47). The Court of Appeals did not answer "No" to Section 1129 of the Bankruptcy Code or to Los Angeles Lumber.

2. The Court of Appeals did not hold solely that the automatic stay of 11 U.S.C., sec. 362(a) permits a debtor to retain possession and use of real estate and any other collateral subject to a creditors lien without providing any protection under 11 U.S.C., sec. 362(d) against decline in the value of the creditor's interest in the property until after expiration of state notice and redemption periods applicable to foreclosure or replevin.

The Court of Appeals at A.10 held that:

> the creditor's right to reinvestment return on foreclosure proceeds should not begin until, under state law, the creditor could have taken possession of the collateral, sold it to a third party, and reinvested the proceeds. American Mariner, 734 F. 2d at 435 N. 12 ("to avoid overcompensating the secured creditor, the timing of adequate protection; should take into account the usual time and expense involved in repossession and sale of collateral.") See also In re Bear Creek Ministorage, Inc., 49 Bankr. 454, 458-9 (Bankr. S.D. Tex. 1985) ; In re South Village, Inc., 25 Bankr. 987, 996, n. 14 (Bankr., Utah 1982).

The Court of Appeals opinion did deal with both forms of adequate protection, for adequate protection is supposed to be a flexible concept geared to the particular case.

---

[1] "A" refers to the Appendix to the Joint Petition.

The Court of Appeals pointed out that the bankruptcy court failed to take into account the fact that land values had declined by at least 24 percent in the twelve-month period immediately preceding the filing of the petitions in bankruptcy. (A.13). Since the Ahlers filed their bankruptcy petition on November 26, 1984 and the bankruptcy court held an eventiary hearing on Norwest's and Federal Land Bank's Motion for relief of stay on February 27, 1985, there could have been no significant post petition or post-motion decline in the value of land or other collateral. The bankruptcy court held that the Petitioners herein were:

> entitled to compensation as adequate protection for the delay of enforcing contractual repossession and foreclosure rights during the interim between the filing of the petition and confirmation of the plan. It is the present value of that interest, the opportunity lost, that must be protected. (A.5) (Also see A.9)

Accordingly, the Court of Appeals held at (A. 12):

> Since their right to foreclosure and to reinvest the liquidation proceeds would give them no financial benefit until the land could be resold to a third party, which at the earliest would be one year and six weeks from the date the foreclosure proceedings were commenced, the Ahlers' adequate protection payments to protect this right to reinvestment returns on foreclosure proceeds should not begin until that date.

Since Petitioners do not present any question regarding adequate protection for lost opportunity or profits resulting from delay (where timing has relevance), this Court should ignore any discussion or arguments concerning this form of adequate protection in the Joint Petition in their entirety.

3. Petitioners misstate their question regarding rehearing. What they might have said was:

> Does 28 U.S.C., Sec. 46(C) require the grant of en banc rehearing of a two-to-one panel decision where four judges vote to deny rehearing, five judges vote to grant rehearing, and the remaining judge is disqualified and does not vote.



Clearly, 28 U.S.C., sec. 46 (c) does not outline the requirements upon which rehearing may be denied. Rather, it outlines on what basis a petition may be granted. 28 U.S.C., sec. 46 (C) does not prevent the Circuit Court from interpreting or providing the Circuit Court from interpreting what constitutes a majority of voting judges (A. 19). This is a false issue contrived to win undeserved sympathy, based on the erroneous concept that judges who voted for rehearing would also vote to reverse the panel. It should be ignored.

## JURISDICTION

It is unclear on what grounds jurisdiction is invoked. Contrary to some of the arguments of the Petitioners, none of the grounds or considerations recited in Rule 17 would appear to be present at bar.

## STATUTES INCLUDED

For the purpose of this Response, Respondents rely on no other statutes than those on page 2 of the Joint Petition. These statutes are recited verbatim at A. 91 et seq. of the Joint Petition.

## STATEMENT OF THE CASE

Petitioner's Statement Of The Case is mere argument and should be stricken on that ground. Such comments as "The decision is thus in stark opposition to the language of the Bankruptcy Code"; "This holding shifts the entire risk of collateral reevaluation from debtors to creditors" and "The background of this sweeping revision of bankruptcy law and sharp division of the Court of Appeals is summarized in the following decision" are a few examples of argument that do not belong in Petitioners Statement of the Case.

For their Statement of the Case, Respondents adopt the "Background" in the opinion of the Eighth Circuit appearing at page 2-6 of the Appendix to the Joint Petition. Additionally, respondents say that on appeal to the Eight Circuit Court of Appeals, a majority of a three-judge panel concluded that the automatic stay should not have been lifted and that the lower courts' determination of feasibility were in error. The Court of Appeals drafted a Proposed Plan to illustrate how the debtors would reorganize so as to pay their creditors allowed claims in full. (A. 37) The Court further held at A.2-3:

> To insure that the plan is fair and equitable and protects the unsecured creditors, the plan should require that any cash flow from the operation of the farm in excess of that anticpated in the plan be paid to the unsecured creditors on a pro rata basis, until such time as unsecured creditors are paid in full without interest. Moreover, the plan should require that if the land is sold during the pendency of the plan, and if the unsecured creditors have not been paid in full before that date, any proceeds exceeding those necessary to pay the secured debt be shared on an equitable basis between the debtor and the unsecured creditors. Finally, the court should not permit the prejudgement seizure of equipment and machinery necessary to carry out the plan even if the creditors offer to post a bond.
>
> We recognize that, under a plan of reorganization, secured creditors become unsecured to the extent that their allowed claim exceeds the value of their interest in the collateral. We hold, however that neither these nor other unsecured creditors can prevent the plan from being approved on the basis of the absolute priority rule if the plan meets the requirements outlined herein and if the debtor agrees to contribute his experience, knowledge, and labor to the successful implementation of the plan.

Petitioners sought rehearing with a suggestion for rehearing en banc. All of the States of the Union in the Eighth Circuit--Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota--opposed rehearing by submitting their joint amicus curiae brief.

Although a plurality of the judges sitting favored rehearing, there was no majority, and rehearing was denied.

Petitioners moved for clarification of the order denying rehearing, which was denied.



The Court of Appeals granted a stay of the mandate at Petitioners request until December 8, 1986 to permit any party to this appeal to file a petition for certiorari with this court. On that day, Petitioners mailed their Joint Petition to this court and on December 9, 1986 it was docketed.

Because there are no available funds to pay for printing costs herein, respondents move to proceed in forma pauperis, and timely submitted this Response pursuant to Rule 46.

## REASONS FOR DENYING THE WRIT

(ARGUMENT)

I.

### The Court of Appeals Has Not Violated Established Legal Principles by Holding That A Contribution of Future Labor, Experience and Knowledge Can Serve To Implement The Plan Of Reorganization

The Court of Appeals Opinion does not violate this Court's decision in Case vs. Los Angeles Lumber Products Co., 308 U.S. 106 (1939), nor is it contrary to the express language and legislative history of 11 U.S.C., sec. 11 29 (b)(2)(B) (ii), nor is it contrary to the decisions of other circuits.

As concluded by the Court of Appeals at A. 27:

> ...The Ahlers would not realize any real profit or benefit from their retained equitable ownership interest until the reorganization plan was completed and the secured creditors had been paid the full amount of their allowed secured claims. At this time, the equitable owndership interest would mature. Thus, if the bankruptcy court determines that the value of the Ahlers' yearly contributions of labor, experience, and other expertise over the life of the plan will equal or exceed the value of the retained ownership interest at maturity, the dissenting unsecured creditors cannot complain that they have not been accorded their full right of priority against the debtors' assets.

This is especially true because admittedly, if the Ahlers were liquidated, the unsecured creditors would receive nothing (A.47). The unsecured creditors in a bankruptcy court of equity cannot assert a valueless right or claim a prejudice that does not

exist. The Ahlers do not retain any property of value to a senior class of unsecured creditors. This is the only way that 11 U.S.C. 1129(b)(2)(B)(ii) makes any sense at all.

This case and the Court of Appeals holdings therein do not resemble Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939); Metropolitan Holding Co. v. Weadcock, 113 F. 2d 207 (6th Cir. 1940), Spitzer V. Stickman, 278 F. 2d 402 (2d Cir. 1960); or Muskegon Motor Specialties, 366 F. 2d 527 (6th Cir. 1966). These are cases involving efforts by shareholders to retain their shares by offering such vague and immeasurable contributions as "continuity of management", "financial standing," and "influence in the community." These are not measurable in money's worth, which was the reason they were rejected as valid contributions in Los Angeles Lumber.

The Ahlers, or any other farmers in like circumstances, are not shareholders who are offering some vague and illusory contribution in order to keep their stock. The Ahlers are contributing their labor, which is clearly and easily measurable in money's worth on the basis of the going rate for farmers of their experience and knowledge. There can be no doubt that such a contribution is permissible.

This Court may well ask how just it is to permit a secured creditor to block the chance of unsecured creditors from ever receiving anything under the plan by the simple expedient of voting its unsecured position which has resulted from its undersecured position. A brief history in that regard is instructive.

The 1970's saw the climax of vast expansions of credit freely and wantonly given. Farm land prices and all other farm prices were permitted to drastically rise in the face of radically increasing demands for farm products. Farm land prices soared 12-fold from 1950 through 1979. In the 1950s, annual interest expense was only 17% of average income from assets, but by 1979 exceeded 50 percent.



Presently agriculture is carrying as much as $100 billion more in debt than it can realistically support. (The Outlook, Wall Street Journal, Mon., Aug. 26, 1985). All of this could have been easily avoided by controlling exports, adjusting farm supports gradually downward; restraining interest rates to modest levels; and restraining the rise of the dollar against foreign currencies.

Instead, as worldwide demand for U.S. grain and fiber boomed, the Government told farmers to farm fence-to-fence and at the same time advised that costly new machines and methods could greatly enhance production and profits. Suddenly, farmland was regarded as "a scarce resource in a hungry world." By now, bankers were going from farm to farm, like Fuller Brush salesmen, urging farmers to borrow. The future seemed secure and bright indeed. Farmers bought enormous amounts of machinery and additional land at greatly inflated prices and interest rates. Debt grew from $50 billion at the start of the 1970's to $200 billion in January, 1985. (See Time Magazine, 2/18/85), p. 27-8). In part, this drastic increase in debt was the result of a change in farm credit system lending policy. In 1971 the system abandoned making loans on the basis of a farm's ability to provide cash flow from operations; it started to lend on the market value of the farm. In 1980, Congress authorized loans up to an irresponsible 97% of those obviously inflated market values. (Wall Street Journal Review and Outlook, p. 22, 12/6/85) Suddenly, farmers had enormous leverage and could borrow huge sums as they pyramided their land holdings. Ordinarily, farmers, who for generations had been taught by their fathers not to overextend themselves, would never have participated in such folly, but this time they were assured that nothing could go wrong by the government and by the nations's more influential and respected lenders and leaders. The stage was set for collapse.

In 1981, the bubble burst as world-wide recession and glut slashed demand for U.S. farm products abroad and prices drastically fell. Suddenly, farmers could no longer make enough from crop sales to cover repayment of their loans. As a result, demand for land and machinery dried up and the value of both dropped precipitously. (See Time Magazine, 2/18/85, p. 28). Overnight, many farmers found they had little or no equity in their land, and thus no ability to borrow further. Because farmers could no longer repay their loans, lenders began to experience heavy losses. The farm credit system generally admits it is insolvent and has received a government bailout in the billions to meet its commitments and assist distressed farm debtors.

We have reached this sorry state not because of government intervention, but rather because of the lack of proper and enlightened intervention, because of government and lender poor advice. It is because the government failed to intervene in a conservative and responsible manner to prevent the boom-and-bust cycle that we now must pay so dearly -- because the government, encouraged by industrial leaders who know far better, added fuel to the speculative fire by urging farmers to drastically and profligately expand and "modernize" their operations.

Farmers, such as the Respondent Debtors, have pledged all they own to their secured lenders, for those were the conditions lenders blithely soft-pedalled when they offered their loans. It is an easy matter for bankruptcy judges to force liquidations of farmers who ostensibly are afforded the protections of the bankruptcy laws. All that is necessary is to construe the Bankruptcy Code strictly against Debtors and interpret the theory of adequate protection in such a way to make reorganization impossible. The Court of Appeals Opinion puts a stop to that practice.



Bankruptcy Judge Richard Stageman of Iowa in November, 1985, testified before the Senate Judiciary Committee that 700,000 farmers will go out of business over the next 5 years. Forty-two percent of FmHA loans in Nebraska are now delinquent and thirty percent of Iowa farmers with less than $800,000.00 in assets are behind in their payments. (Chicago Tribune, Monday, February 4, 1985, "Bank failure tightens noose on rural town.") The number of farm foreclosures continues to escalate throughout the Midwest. During 1985, the St. Paul District of the Federal Land Bank has been first in foreclosure over all other districts, which reflects a disturbing "creditors orientation" and creditor bias by Bankruptcy Courts in the St. Paul District. The view that, if a farmer does not have the support of the secured creditors in a consensual reorganization, he can not reorganize has reached full flower--largely through the astounding influence of lenders.

The Ahlers are not financial experts, captains of industry, Philadelphia lawyers, or agri-business leaders. They are plain folks who have depended upon prominent persons in their community and their government for guidance. They have especially depended on the Federal Land Bank and Norwest Bank to assist them, to forbear, to deal fairly with them and in time of need to help them through. How disappointed the Ahlers are, and all Americans must be, in the shameful and disgraceful performance of these great American institutions. At a time when their assistance, cooperation, and forebearance are needed, they seek advantage and protection of their own short-range self interest (which in the end must result in enormous damage to themselves and to the nation.) It is incomprehensible that Norwest and Federal Land Bank would prefer disasterous liquidation losses rather than performing loans on their books. Equity is all on the side of the Ahlers.

There are some farmers who are not in immediate danger. Some of them see their future success in the demise of their neighbors, which they believe will cause shortage and a restoration of drastically, inflated prices. There are also profiteers who hope to purchase land at ridiculously low prices. There are also those lenders who have made the dreadful decision to foreclose on a widespread basis, who have enormous inventories of farm land and see their only salvation in the restoration of high farm prices and resulting premium prices for land. Many of these voices demand the demise of distressed farmers to their own detriment. This Court should do all in its power to prevent and discourage such folly.

The impact of the Court of Appeals decision will enhance the prospects of all parties to a Chapter 11 proceeding including creditors who will have performing loans on their books or the prospect of payment where there was none.

There would be little criticism, Respondents venture to say, if a large corporation offered a renegotiated contract with its unions, permitting it to make a healthy profit, as its contribution to its plan so that is could retain ownership of its plant or business. Such contributions of labor are clearly measureable in money's worth and are legitimate means of implementing a plan.

To be sure, vague contributions of "management," etc. were criticised both in this Court and Congress, but no such vague contributions are offered by debtors in this case. The cases and legislative history reliedon by Petitioners have no relevance here.

The holdings of the Court of Appeals admit of no possibility that debtors in every Chapter 11 case may leave unsecured creditors unpaid at the end of the plan and reap all future profits and benefits for themselves. Rather, the Court of Appeals holdings assure that unsecured creditors have a realistic opportunity of receiving full or substantial payment, rather than little or nothing. There is no evidentiary support for the concept that the Ahlers are insolvent by a wide margin or have no significant cash flow or cannot reorganize. The Eighth Circuit's proposed plan puts an end to that fiction. (A. 37). The fact is that the evidence of the debtors' cash flow and surplus under the debtor's plan stood unrefuted in the bankruptcy court.



II.

The Decision of the Court of Appeals Is Not Contrary To The Requirements Of Adequate Protection, Does Not Conflict With The Views Of Other Circuits And Does Not Vindicate The Rights Of Secured Creditors in Bankruptcy.

As previously stated, Petitioners present no question regarding adequate protection for lost opportunity, and any argument concerning this form of adequate protection should be disregarded.

Petitioners arguments on adequate protection are in reality nothing more than their great dissatisfaction with the foreclosure and redemption laws of Minnesota and the length of time it takes to possess property free and clear.

Petitioners' logic is flawed. Respondents adopt and rely on the Court of Appeals opinion.

Adequate protection is a flexible concept to be equitably tailored to each case and need not involve immediate cash payments for declines in property values that may never occur.

Adequate protection payments should not begin until the lender could conceivably suffer some risk of loss that it is not already bound to assume--that is only fair. As explained in the Court of Appeals opinion, any risk of loss on land could not realistically occur until the process of foreclosure is completed and redemption rights expire. Adequate protection should run from that time. The idea that there might be a market for farm land encumbered with redemption rights is preposterous in light of the thousands of free and clear acres presently available.

The charge by petitioners that the decision in Ahlers would double the time is specious. Creditors' remedy is to prove to the bankruptcy court that no reorganization is possible by diligently expediting the debtor's confirmation hearing and demonstrating at that time that no debtor plan is feasible.

A secured creditor is not entitled to compensation for a risk of loss that it has already assumed. It would make no difference what the practical effect of this might be on the lender due to state law.

Few if any bankruptcy courts would be disposed to allow a debtor more than a year and six months to confirm a plan if adequate protection were not available. It should be emphasized that there are many other reasons for lifting stay than failure to provide adequate protection.

No lender is being put unnecessarily at risk, since the risk was assumed under state law at the time the loan was made.

III.

The Decision Denying Rehearing
En Banc In The Court Of Appeals Was Proper.

As stated in the Joint Petition at page 19, this Court has determined that "Where a Court of Appeals by rule or generally promulgated practice requires that non-voting judges be considered in determining whether there is an affirmative majority, that practice will not be disturbed by this Court". Shenker v. Baltimore/Ohio Railroad Co., 374 U.S. 1, 4-5 (1963).

Petitioners infer, but do not directly contend, that a disqualified judge is not a "non-voting" judge and reinforces this thought with the further innuendo that the disqualified judge would have voted in Petitioner's favor.

The fact is, however, that the disqualified judge could have easily, in the course of his representation of Federal Land Bank, gained an antipathy toward it and all it represents from confiden-



tial information entrusted to him--all of which would assure his vote in favor of respondents. We shall never know. Moreover, there is no reason to believe that the five who voted for rehearing did so from any conviction that the panel opinion was wrong, except for Judge Gibson.

An absolute majority of the sitting judges in regular active service is fair because the panel opinion, even though divided, deserves this deference and an absolute majority assures that the entire court's time need not be unnecessarily wasted.

As previously stated, this is a false issue contrived to win undeserved sympathy and hearing in this Court.

CONCLUSION

In an effort to address the financial problems of the Ahlers, and other farmers like him, which have been caused not by them but by lenders, agri-business and government--a crisis only very latterly admitted by Petitioners--the Court of Appeals has given bankruptcy law a realistic meaning that likely may be the salvation of our nation as we know it.

Clearly, our nation cannot afford any further decline in the farm economy. A further severe decline is bound to occur if some protection is not afforded ailing farmers.

As stated in some of the Amicus briefs, Congress has recently enacted Chapter 12 of the Bankruptcy Code. It is vital that Court of Appeals opinion remain in place for the following reasons:

a. It is uncertain as yet whether Chapter 12 offers protection to family farmers like the Ahlers: and Chapter 11 as enhanced by Ahlers offers a transitional alternative.

b. It is as yet uncertain whether debtors such as the Ahlers may convert to Chapter 12, and the Court of Appeals protection in Chapter 11 may turn out to be their only alternative.

c. No sweeping changes have been made, no concepts have been radically altered, and there is no serious impairment, but rather enhancement of creditor's prospects.

There are no serious and grave issues herein for all creditors in Chapter 11 bankruptcy cases, only the selfish desire of some secured creditors to retain a power to determine which farmers shall survive and which shall not. Ahlers is working beautifully so far, and it would be a shame if an opinion so clearly in the public interest should not be given time to work.

Respondents respectfully request that the Joint Petition for Certiorari be denied.

Dated: January 23, 1987

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# REPLY

# BRIEF

NO. 86-958

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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NORWEST BANK WORTHINGTON AND FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,

*Respondents.*

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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**NO. 86-958**

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NORWEST BANK WORTHINGTON AND FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,

*Respondents.*

---

## JOINT REPLY OF PETITIONERS

---

Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul submit this Reply pursuant to Supreme Court Rule 22.5 in response to Respondents' opposition to the joint petition for a writ of certiorari.

### SUMMARY OF REPLY

Respondents' opposition is an attempt to imply that the decision below (*"Ahlers"*) reflects merely an equitable exercise to assist two beleaguered farmers. Their opposition ignores the impact that *Ahlers* will have and is having not only upon secured agricultural lenders but upon creditors in commercial transactions in general. The various *amicus*

*curiae* briefs, such as that of the American Council of Life Insurance, demonstrate the sweeping importance of the issues raised by the decision below. Respondents do not and cannot contend that the questions presented are unimportant, and even the *amicus curiae* opposition by certain state attorneys general stresses the importance of the issues.

The decision below is already having a substantial impact upon farm and non-farm bankruptcies alike, and is reflective of the extreme division among the Circuits regarding fundamental questions of adequate protection under the 1978 Bankruptcy Code. *Ahlers* does not reflect merely a "transition" for farmers pending utilization of the new Chapter 12 of the Bankruptcy Code, but rather distorts fundamental premises of Chapter 11 and precludes uniformity of application of Chapters 11 and 12. The issues presented reflect the foremost controversies existing in bankruptcy law today, issues which will affect literally thousands of bankruptcy cases and commercial lending practices for years to come. To assure uniformity of federal bankruptcy law, to resolve serious divisions among the Circuits, to assure compliance with this Court's precedent, and to address immediate problems in the administration of the bankruptcy laws, the petition for certiorari should be granted.

## ARGUMENT

### I.

**Certiorari should be granted to resolve conflicts among the Circuits and to provide guidance for provision of adequate protection to secured creditors.**

Subsequent to the Petition herein, the Court of Appeals for the Fifth Circuit issued its sharply divided decision on



rehearing *en banc* in *In re Timbers of Inwood Forest*, No. 85-2678 (5th Cir., Jan. 9, 1987), reinstating the panel decision in that case reported at 793 F.2d 1380 (5th Cir. 1986). That decision accentuates the direct conflict among the Circuits regarding application of the key provision of the 1978 Bankruptcy Code for "adequate protection" of the rights of secured creditors in bankruptcy. *Compare In re Timbers of Inwood Forest*, 85-2678 (5th Cir. Jan 9, 1987) (en banc) *with Grundy National Bank v. Tandem Mining Corp.*, 745 F.2d 1436 (4th Cir. 1985); *In re American Mariner*, 734 F.2d 426 (9th Cir. 1984). *Cf. In re Briggs Transportation Co.*, 780 F.2d 1339 (8th Cir. 1985). *Ahlers*, by failing to provide protection against decline in value of collateral, is at odds with each Circuit Court to have considered the issue of adequate protection.

Under the 1978 Bankruptcy Code, "adequate protection" is the constitutionally mandated provision to protect creditors' secured interests in property while allowing bankrupt debtors to continue to use the property. *Ahlers* eviscerates that protection by delaying it so as to preclude any protection at all. The upshot of *Ahlers* is thus that a secured creditor may never be entitled to protection of its interest in collateral, notwithstanding decline in the value of its collateral during the pendency of the bankruptcy case.

The problems created by *Ahlers* are already being experienced in the lower courts. Respondents state (Opposition, p. 15) that *"Ahlers* is working beautifully so far, and it would be a shame if an opinion so clearly in the public interest should not be given time to work." But beauty is in the eye of the beholder, and experience to date suggests that *Ahlers* is not being limited but necessarily followed by the lower courts required to abide by that divided panel

decision. *See, e.g., In re Haukos Farms, Inc.*, No. 3-85-445 (Bankr. D. Minn. Dec. 31, 1986) ("*Ahlers* . . . apparently renders illusory the concept of adequate protection for real estate mortgagees . . ."); *In re Blackford Farms, Inc.*, No. 85-00839C (Bankr. N.D. Iowa Dec. 18, 1986) (no protection against decline in value of collateral until after expiration of the time necessary for foreclosure, sale, and reinvestment); *In re Asbridge*, 66 B.R. 894 (Bankr. D. N.D. 1986) (Mortgagee has no right to adequate protection until expiration of all delays attendant upon foreclosure, and if debtor shows there is then no ready market for sale, debtor need provide as "adequate" protection only $3.50 per acre as annual rent; under *Ahlers*, there is no need to protect against decline in value, and no need to protect against accruing real estate tax liens). The *Ahlers* reasoning on adequate protection has also been followed outside the Eighth Circuit. *See In re Bessey*, 65 B.R. 638 (Bankr. S.D. Cal. 1986) (non-farm case holding that the right to adequate protection does not arise until after expiration of foreclosure periods, plus "anticipated" time for resale, including time necessary to complete repairs).

By conditioning the fundamental right to adequate protection upon a speculative determination of what would have happened to the creditors' investment "but for" the stay of bankruptcy, *Ahlers* and its progeny effectively deny provision of any protection at all.[1] The result is attractive to

[1]Respondents imply that there has been no loss to Petitioners due to lack of adequate protection because "there could have been no significant post petition or post-motion decline in the value of land or other collateral" (Opposition, p. 3). In fact, however, Norwest's collateral value declined from $468,482.48 on the date of filing (A. 65), to $210,062.00 on July 2, 1986. (A. 44, 46). Federal Land Bank's collateral value was found to be $624,000.00 at the time of filing (A. 62), and had declined to $305,998.00 as of the date of the plan drafted by the Court of Appeals (A. 46). Under *Ahlers*, these declines have been without protection.



bankrupt debtors, but is contrary to decisions of other Circuits, to the purpose of the Bankruptcy Code, and to constitutional protections of property rights.

## II.

**By combining avoidance of adequate protection with impairment of the absolute priority rule, *Ahlers* impermissibly impairs the rights of creditors in bankruptcy proceedings.**

The adverse impact of *Ahlers* on the rights of creditors is compounded by its disregard of the absolute priority rule. The central premise of reorganization under Chapter 11 is that creditors whose claims are impaired under a proposed plan may vote to accept or reject the plan; in voting, the creditors must make a judgment as to whether they would fare better in a liquidation than under the debtor's proposed plan of reorganization. *Ahlers* effectively removes the right of creditors to withhold consent. Under *Ahlers*, so long as a debtor promises to contribute his future experience, knowledge and labor to implement the plan, the bankrupt debtor may confirm a plan to retain his property despite the objections of unpaid creditors.[2]

While depriving creditors of basic protections established by Congress in 11 U.S.C. § 1129(b)(2)(B) and by this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), *Ahlers* also assures delay and protracted litigation. With no obligation to provide any adequate protection until after expiration of all delays which would be attendant upon foreclosure and resale, a debtor

[2]The "plan" drafted by the Court of Appeals in *Ahlers* is premised upon erroneous valuations and optimistic predictions of cash flow, and the payments by the debtors to creditors would be made over *thirty* years (A. 40, 47), during which time the debtors would retain use and possession of all property, and the creditors would continue to bear the risk of loss. The debtors' contribution of labor, experience and management over this time will enable them to retain all the property, whether or not the unsecured claims are paid (A. 25).

will be encouraged to delay proposing a plan of reorganization until the adequate protection obligation arises, for if the collateral value declines in the interim, the amount to be protected will be lower. Even then, nothing need actually be paid as adequate protection until funds are available from the debtor's cyclical business operations. To confirm a plan of reorganization at that point, the debtor need only satisfy the then-reduced value of the secured claims, and, by a promise of future contributions of experience, knowledge, and labor, may use 11 U.S.C. § 1129(b) to "cram down" a reorganization over objections of unpaid creditors.

Respondents suggest (Opposition, p. 13) that the creditors' remedy "is to prove to the bankruptcy court that no reorganization is possible by diligently expediting the debtor's confirmation hearing and demonstrating at that time that no debtor plan is feasible." But where the debtor has every incentive to delay, where there is no obligation to provide adequate protection, and where the debtor may ultimately cram down a plan through a promise of future contribution of management, knowledge, and labor, the ability of creditors to expedite the process is likely to be illusory. Moreover, the congested condition of the bankruptcy courts in economically troubled areas is well-known, and such expedited relief may simply not be attainable.

## III.

**As applied to farm bankruptcies, *Ahlers* causes serious distortion and lack of uniformity in federal bankruptcy law.**

Subsequent to the decision below, Congress enacted Chapter 12 of the Bankruptcy Code to deal with special problems of farmers. Respondents suggest (Opposition, p.



14) that "it is uncertain as yet whether Chapter 12 offers protection to family farmers like the Ahlers; and Chapter 11 as enhanced by *Ahlers* offers a transitional alternative."

*Ahlers*, however, is not merely a transition to Chapter 12 but a substantive departure from established principles of Chapter 11 proceedings. Chapter 12 does not preclude farmer-debtors from filing under Chapter 11, and *Ahlers* in fact provides a farmer-debtor with far greater benefits than Congress afforded in its deliberative process in enacting Chapter 12. For example, unlike the delay encouraged by *Ahlers*, Chapter 12 requires filing of a plan within 90 days of filing for relief, and requires expedited hearing for confirmation. 11 U.S.C. §§ 1221, 1224. Unlike *Ahlers*' total lack of adequate protection payments for an extended period, Chapter 12 provides for cash payment or replacement liens to cover declines in property value or as cash rent for the property involved. 11 U.S.C. § 1205.

Under *Ahlers*, a farmer-debtor who happens to reside in the Eighth Circuit will thus have greater bankruptcy protections under Chapter 11 than will similar debtors filing under Chapter 12 in other Circuits. As a result, *Ahlers* frustrates the Congressional balancing of interests in enacting Chapter 12.[8]

---

[8] *Ahlers* will also preclude uniformity of Circuits' law under Chapter 12: Chapter 12's provisions for adequate protection payments, 11 U.S.C. § 1205, are conditioned upon adequate protection otherwise being "required" under 11 U.S.C. §§ 362, 363, or 364; a Chapter 12 debtor in the Eighth Circuit thus will argue that no Chapter 12 obligations can arise until such time as adequate protection would be required under *Ahlers*.

The result of *Ahlers* is an unacceptable departure from uniformity in important federal law. *Ahlers* has clearly usurped the legislative process, and its error must be remedied.

## CONCLUSION

Judge Gibson's observations for the dissenting majority on the petition for rehearing in *Ahlers* provide an apt summary:

> "The court has altered the relationship between debtor and creditor, invading serious policy issues properly the concern of Congress . . .
>
> * * *
>
> This case, however, can now be solved only in the Supreme Court. We are left to hope that, upon proper petition, it will grant certiorari."

Respectfully submitted,

Dated: February 5, 1987

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# AMICUS CURIAE

# BRIEF

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# In the Supreme Court of the United States

OCTOBER TERM, 1986

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NORWEST BANK WORTHINGTON and FEDERAL LAND BANK OF ST. PAUL, PETITIONERS

*v.*

JAMES R. AHLERS and MARY M. AHLERS

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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## QUESTIONS PRESENTED

1. Whether an undersecured creditor's entitlement to "adequate protection," during reorganization proceedings, against declines in the value of its interest in the debtor's property, and against the "opportunity cost" of not being able to reinvest the value of that interest, begins immediately on filing of its claim or on the later date when, under state law, the creditor could have received the proceeds of a foreclosure sale of the property.

2. Whether the rule allowing a debtor in reorganization to overcome the absolute priority of creditors by contributing needed fresh capital may be satisfied by treating an individual debtor's "labor, experience, and expertise" as the equivalent of fresh capital.

3. Whether 28 U.S.C. 46(c) requires a court of appeals to grant rehearing en banc when five judges vote in favor of rehearing en banc, four vote against, and one is recused.

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

---

This brief is submitted in response to the Court's invitation to the Solicitor General to express the views of the United States.

## STATEMENT

1. This case arises from the bankruptcy petition of respondents James and Mary Ahlers. Respondents farm land in Nobles County, Minnesota. Between 1965 and 1982 they obtained four loans from petitioner Federal Land Bank of St. Paul (FLB) and secured each of those loans with a separate parcel of land that they owned (Pet. App. A3). Between 1982 and 1984, respondents obtained additional loans from petitioner Norwest Bank Worthington (Norwest). The security for those loans was a second mortgage on the parcels already securing FLB's loans and a first mortgage on respondents' farm

machinery, farm equipment, crops, livestock, and other farm proceeds. *Id.* at A4.

Respondents defaulted on their loans. Norwest, exercising its rights as a secured creditor, filed a replevin action in Minnesota state court seeking possession of respondents' farm equipment and machinery (Pet. App. A4). Two weeks later, respondents filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 1101 *et seq.* (Pet. App. A4-A5). This petition automatically stayed Norwest's collection efforts in state court (11 U.S.C. (& Supp. III) 362(a)).

2. a. Petitioners filed motions in bankruptcy court for relief from the automatic stay, see 11 U.S.C. (& Supp. III) 362(d), asserting that respondents could not provide them adequate protection. The bankruptcy court granted both motions. FLB had requested relief from the stay in order to foreclose on two of the four parcels that secured respondents' outstanding loans. The loans that those two parcels secured were in default, and FLB claimed that the value of those parcels was significantly less than respondents' outstanding obligations. The bankruptcy court, after hearing conflicting testimony on the value of this land, concluded that the current value of those two parcels did not approach the outstanding balances on the loans that they secured. The court held that in these circumstances FLB was entitled to either adequate protection against the "opportunity cost" of not being able to foreclose its mortgage and reinvest the proceeds or, in the absence of such protection, relief from the stay so that those state-law rights could be pursued. Pet. App. A62-A63. Because respondents had not suggested any means for providing adequate protection, the court concluded that only periodic payments of interest would maintain the value of FLB's interest in its collateral (*id.* at A63). Respondents admitted that they could not make such payments, and the bankruptcy court accordingly granted FLB relief from the stay (*id.* at A63-A64).



The bankruptcy court also granted Norwest's motion for relief from the automatic stay. Although the value of the collateral securing Norwest's claims had exceeded the amount of those claims when the bankruptcy petition was filed, the court determined that the value of the collateral had since decreased so that it was now less than Norwest's claims (Pet. App. A65-A66). Thus, like FLB, Norwest was undersecured and entitled to adequate protection. Respondents had offered Norwest a lien on their anticipated 1985 crops, but the court held that such a lien could not provide adequate protection (*id.* at A66 n.9). Thus, as with FLB, Norwest could be provided adequate protection only through periodic payments, which respondents admitted they could not provide. Accordingly, the bankruptcy court granted Norwest's motion to lift the automatic stay. Respondents appealed this decision to the district court.

b. The district court denied respondents' motion to stay petitioners' collection efforts pending its resolution of the appeal but agreed to enjoin petitioners from initiating any foreclosure proceedings pending appeal of the denial of the stay motion to the court of appeals. The court of appeals issued a stay and remanded the case to the district court for adjudication of respondents' appeal (Pet. App. A75-A77). In so doing, the court noted that respondents' 1985 crops were not subject to any liens and that those crops "have a value sufficient to reasonably insure that neither creditor will be further harmed if foreclosure and repossession proceedings are stayed" (*id.* at A76). The court gave petitioners a lien on those crops, stayed any further collection efforts, ordered respondents to provide Norwest with assurances that all farm machinery and equipment was fully insured, and requested that the district court determine the merits of the case, including the probability of success of respondents' proposed plan of reorganization (*id.* at A76-A77).

c. The district court affirmed the bankruptcy court's order granting petitioners relief from the automatic stay.

The court upheld, as not clearly erroneous, the bankruptcy court's finding that FLB was undersecured on the two parcels of land on which it sought foreclosure. Because respondents had not offered any means of providing FLB with adequate protection, the court agreed with the bankruptcy court that FLB was entitled to relief from the stay. Pet. App. A84-A85. The court also affirmed the bankruptcy court's findings that Norwest was undersecured and that the existing crops could not provide Norwest with adequate protection, as well as the bankruptcy court's order lifting the automatic stay (*id.* at A85-A86).

Pursuant to the instructions of the court of appeals, the district court then evaluated the likelihood of success of respondents' proposed plan of reorganization. The court found that no such likelihood existed. Three facts doomed any chance that respondents would have of successfully reorganizing: respondents had an asset-to-liability ratio of .67 to 1, they had "failed to establish their ability to operate profitably in the future," and American farmers in general face oppressive economic conditions that are unlikely to improve soon. Pet. App. A87.

3. a. The court of appeals reversed the bankruptcy court's order granting petitioners relief from the automatic stay. The court stated that the purpose of adequate protection is, "as nearly as possible under the circumstances of the case, [to] provide the [secured] creditor with its bargained-for rights" (Pet. App. A7). The court held that this compensation can include payment for the lost opportunity to reinvest the proceeds of a foreclosure sale, and it refused to overturn the bankruptcy court's determination that such payments were appropriate in this case (*id.* at A9). The court of appeals held, however, that the lower courts had erred in determining the time as of which adequate protection should begin.

The court of appeals held that adequate protection payments should begin only after the time when a secured



creditor would have realized the proceeds of foreclosing on the collateral if the debtor had not filed a bankruptcy petition. The court reasoned that those payments are compensation for abridgment of the secured creditor's bargained-for right to foreclose on the collateral in the event of default, liquidate the collateral, and reinvest the proceeds (*id.* at A9-A10). Thus, the court found it necessary to determine "the date when the creditor, absent the filing of a bankruptcy petition, could have taken possession of the collateral under state law and could have sold it to a third party, the amount that the creditor would have realized at this sale, and the creditor's expected return upon reinvestment" (*id.* at A10).

Applying these principles, the court determined that neither petitioner was immediately entitled to payments on its security interests in respondents' farmland. The court based this holding on the provisions of Minnesota foreclosure law. Under this law, a notice must be published six weeks before a forced foreclosure sale of farmland (Pet. App. A11). State law also allows the mortgagor a 12-month redemption period following a foreclosure sale, during which he is entitled to possession, rents, and profits of the land (*ibid.*). This redemption period, the court reasoned, would make it "extremely unlikely that a third party would purchase the property at the foreclosure sale" (*ibid.*). Thus, were petitioners to exercise their state-law right to foreclose, the probable outcome would be that petitioners would purchase the property at the foreclosure sale and, after the 12-month redemption period had expired, sell the property to a third party (*id.* at A12). Under this scenario, petitioners would not receive (and could not reinvest) any proceeds from respondents' farmland until one year and six weeks after they began the foreclosure proceedings. The court therefore ruled that adequate protection payments for petitioners' security interests in respondents' farmland should not begin until 13½ months after respondents filed for bankruptcy (*ibid.*).

The court concluded, on the other hand, that Norwest was entitled to immediate adequate protection payments for its interest in respondents' personal property. Again the court turned to state law. Minnesota law allows creditors such as Norwest to take possession of personal property promptly after default unless the debtors were dependent on such property for their living. To the extent that the debtor is dependent on particular personal property, he can retain it only if he insures it and makes periodic payments to the creditor (Pet. App. A12). In other words, in the absence of a bankruptcy proceeding, Norwest could have immediately obtained either its collateral or periodic payments. In these circumstances, the court held that adequate protection payments for this property should begin as soon as Norwest applied for such payments. The court held that Norwest was also entitled to immediate adequate protection payments for its interest in respondents' stored grain and livestock because such assets could be liquidated quickly (*ibid.*).[1]

b. The court then addressed petitioners' argument that the automatic stay must be lifted because of the district court's finding that respondents' proposed reorganization was not feasible. Section 362(d)(2) of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 362(d)(2), requires a court to lift the automatic stay if the debtor has no equity in the property on which the creditor seeks to foreclose and the property is not necessary to an effective reorganization. All agreed that respondents have no

[1] The court also held that the district court placed erroneous values on respondents' farmland for adequate protection purposes, even if it was not error for the district court to value the land as of the date the petition was filed instead of the date that the secured creditor could have sold it (Pet. App. A13). The court then ruled that, because they were farmers, respondents could make adequate protection payments when the crops are harvested rather than every month (*id.* at A14). Finally, the court overturned the district court's holding that 1985 crops could not provide adequate protection (*ibid.*).



equity in their property, and petitioners argued that, because respondents have no likelihood of an effective reorganization, it follows that none of their property could be necessary to a reorganization. The court agreed that, if a reorganization was not feasible, the stay should be lifted (Pet. App. A15). The court, however, reversed the district court's finding that there was not a reasonable likelihood of a successful reorganization. The court concluded that the district court erred in using, for this purpose, the valuation determinations that the bankruptcy court had made in ruling on the adequate protection issue. Rather, the court held that the valuation had to be based on the likely value of the property at the time that the plan would be confirmed (*id.* at A16). The court, in dictum, opined that respondents could indeed propose a feasible reorganization plan (*id.* at A17-A19, A37-A49).

The court next rejected petitioners' contention that their legitimate objections to the plan would preclude any successful reorganization. Petitioners argued that, because their claims were drastically undersecured, any plan of reorganization would have to treat them as unsecured creditors for this portion of their claims (see 11 U.S.C. 506(a)). Further, they said, the plan proposed by respondents did not provide for full payment of those unsecured claims, yet it allowed respondents to retain an interest in the farm. Thus, petitioners argued that the plan did not satisfy the absolute priority rule embodied in 11 U.S.C. (& Supp. III) 1129(b) and could not be confirmed over their objections.[2]

[2] Section 1129(b) provides in pertinent part:

> (1) * * * the court * * * shall confirm the plan * * * if the plan does not discriminate unfairly, and is fair and equitable [to dissenting creditors].
>
> (2) For the purpose of this subsection, the condition that a plan be fair and equitable * * * includes the following requirements:
>
> * * * * *
>
> (B) With respect to a class of unsecured claims—

The court, however, disagreed with petitioners' interpretation of Section 1129. It interpreted that section as applying a "modified version of the traditional absolute priority rule" (Pet. App. A22), under which respondents' plan could be affirmed over petitioners' objections so long as respondents retain an interest that does not exceed the future value of their "labor, experience, and expertise" (*id.* at A26). The court relied on this Court's decision in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), which it read as allowing a debtor to participate in a reorganization so long as he "contributes to the reorganization enterprise something that is reasonably compensatory and is measurable" (Pet. App. A24). The court then reasoned that respondents' promise of future labor met this requirement, and respondents could retain an equity interest in the property equal to the value of their labors.

c. Judge Gibson dissented. He took issue with the majority's rejection of the district court's findings that petitioners were entitled to adequate protection payments beginning immediately. He argued that the appellate court could only review such determinations under the clearly erroneous standard and concluded that the record adequately supported the district court's findings. Pet. App. A28-A30.

Judge Gibson also faulted the majority's interpretation of *Los Angeles Lumber*. He read that opinion as allowing debtor participation in a reorganization only when the debtor contributes cash or contributions "distinctly capital in nature" (Pet. App. A34). Judge Gibson argued that, because respondents' labor clearly did not fall within this narrow exception to the absolute priority rule, the plan could not be confirmed (*id.* at A34-A35).

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.



4. Of the 10 judges in regular active service on the court of appeals, five voted in favor of rehearing en banc, four voted against, and one recused himself (Pet. App. A51-A58). Because the five votes did not constitute a majority of the 10 active judges, rehearing en banc was denied. See 28 U.S.C. 46(c); Fed. R. App. P. 35(a); 8th Cir. R. 16(a). Four of the five judges who voted for rehearing en banc joined an opinion that labeled the court's ruling on the absolute priority issue "directly contrary to * * * *Los Angeles Lumber*," noted that, "in some future case, there may be sufficient votes to enable this court to revisit the issue," and expressed the hope that this Court would grant certiorari (Pet. App. A54-A55). The other dissenting judge expressed tentative agreement with the panel dissent (*id.* at A54).

## DISCUSSION

The petition in this case raises three issues. One of those issues is insubstantial,[3] but the other two, the "ade-

[3] Petitioners assert (Pet. 17-20) that 28 U.S.C. 46(c) required the court of appeals to grant rehearing en banc because five of nine nonrecused judges voted for such rehearing. This Court, however, determined in *Shenker* v. *Baltimore & O.R.R.*, 374 U.S. 1, 4-5 (1963), that a court of appeals could deny rehearing en banc when four of six participating judges voted for rehearing, with two abstentions. Petitioners attempt (Pet. 19) to distinguish *Shenker* because in this case Judge Magill did not abstain but recused himself, but *Shenker's* reasoning admits of no such distinction. The *Shenker* Court reiterated (374 U.S. at 4-5) the observations in *Western Pacific R.R. Corp.* v. *Western Pacific R.R. Co.*, 345 U.S. 247, 250 (1953), that Section 46(c) is "not addressed to litigants [but] to the Court of Appeals" and is "a grant of power" but "goes no further." Given the "discretion" recognized in *Shenker*, 374 U.S. at 5, and this Court's reluctance to regulate "the internal administration of the Courts of Appeals" (*ibid.*), there is nothing inappropriate in the existence of different prac-

quate protection" and "absolute priority" issues, touch on important matters that may well deserve this Court's review in an appropriate case. There is disagreement among the courts of appeals about what constitutes "adequate protection," with one court of appeals maintaining that the debtor need only protect the value of the secured creditor's collateral, two holding that truly adequate protection must also include compensation for the lost opportunity of realizing a return on the proceeds that would have been generated at a foreclosure sale, and the court below leaving the issue to case-by-case resolution. The proper scope of the absolute priority rule, on the other hand, has generated little debate over the years, since the governing rules were clearly set out in *Case* v. *Los Angeles Lumber Products Co., supra*—from which the court below took a marked departure. If the approach to absolute priority taken by the court of appeals in this case were to proliferate, the debtor-creditor relationship would be fundamentally and unjustifiably altered. On this issue, the Court may wish to consider summary reversal.

We nevertheless believe that, if the Court is not disposed to reverse summarily, it should deny certiorari. As to adequate protection, the important "opportunity cost" issue is not actually presented by the petition, as the resolution below was favorable to petitioners. What was determined unfavorably to petitioners was the *timing* of adequate protection payments. Although we believe that the court of appeals inadequately analyzed this issue, the timing issue is not the subject of any conflict among the courts of appeals and does not warrant review before further development of the matter in the lower courts. As to the radical departure by the court of appeals from settled principles of absolute priority, we regard the decision below as an aberration that is unlikely to be followed

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tices in the court below and in the Fourth Circuit (see *Arnold* v. *Eastern Air Lines*, 712 F.2d 899 (4th Cir.), cert. denied, 464 U.S. 1040 (1983); see also 4th Cir. R. 35(b)).



elsewhere and may not even survive for long in the Eighth Circuit. Moreover, Congress has substantially amended the Bankruptcy Code's provisions to offer relief to family farmers. The impact of the decision below is therefore uncertain.

1. Section 362(d)(1) of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 362(d)(1), entitles a party with an interest in property of the debtor to relief from the automatic stay if the debtor does not provide him with "adequate protection." Section 361 defines how such protection may be given: through periodic payments that reimburse the creditor for decrease in the value of his interest in the collateral caused by, among other things, the automatic stay (11 U.S.C. (Supp. III) 361(1)), by granting the creditor additional liens to compensate him for this decrease (11 U.S.C. 361(2)), or by "granting such other relief • • • as will result in the realization [by the creditor] of the indubitable equivalent of [the creditor's] interest in such property" (11 U.S.C. 361(3)).

Courts have split over the meaning of this definition of "adequate protection." All courts agree that, in order to prevent the automatic stay from being lifted, a debtor must protect an undersecured creditor from any decrease over time in the value of the collateral. See, *e.g.*, *In re Timbers of Inwood Forest Associates*, 808 F.2d 363 (5th Cir. 1987) (en banc), reinstating 793 F.2d 1380 (1986), petition for cert. pending, No. 86-1602; *Grundy National Bank* v. *Tandem Mining Corp.*, 754 F.2d 1436 (4th Cir. 1985); *In re American Mariner Industries*, 734 F.2d 426 (9th Cir. 1984). They disagree, however, about whether "adequate protection" also requires the debtor to compensate the creditor for the lost opportunity to earn a return by selling the collateral and investing the proceeds. Two courts of appeals, ruling in favor of such compensation, stress that the purpose of adequate protection is to give the secured creditor the "benefit of his bargain" by placing him in the same financial position he would have been in but for the bankruptcy petition.

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See *Grundy National Bank* v. *Tandem Mining Corp.*, *supra*; *In re American Mariner Industries*, [redacted] *supra*.[4] Another court of appeals, opposed to this compensation, relies on the congressional desire to facilitate reorganizations. See *In re Timbers of Inwood Forest Associates*, *supra*; see also *In re South Village, Inc.*, 25 Bankr. 987 (Bankr. D. Utah 1982).[5] The Eighth Circuit has taken a middle road, holding that the appropriateness of lost opportunity costs should be determined on a case-by-case basis. *In re Briggs Transp. Co.*, 780 F.2d 1339 (1985).[6]

The petition, although it discusses this issue and describes the circuit conflict, does not present this question. The court of appeals upheld the bankruptcy court's ruling that petitioners *should* receive compensation for opportunity cost. Petitioners, who benefit from that holding, are obviously in no position to challenge it. Respondents have chosen not to challenge it (see Br. in Opp. 12), have not cross-petitioned, and have not asked for the more favorable rule of *In re Timbers*.

The issue that petitioners legitimately place before the Court concerns the timing of adequate protection payments. The court of appeals said that the purpose of adequate protection payments is to ensure that the secured creditor is left in the same position as he would have been in outside of bankruptcy. The court then

[4] Commentaries advocating this interpretation include Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 115-116 (1984), and Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. Chi. L. Rev. 305 (1983).

[5] This position is advocated in Note, *"Adequate Protection" and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy*, 100 Harv. L. Rev. 1106 (1987).

[6] For a similar position, see Nimmer, *Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness*, 68 Minn. L. Rev. 1, 18 (1983).



looked to Minnesota law and delayed the start of adequate protection payments until the date on which petitioners could have realized the proceeds of sale of the secured property through foreclosure proceedings under state law.

The matter is more complex than the opinion of the court of appeals would suggest. In instances in which the Chapter 11 proceedings do ultimately lead to sucessful reorganization, the delay in providing adequate protection does parallel the delay imposed by state law before a creditor may enjoy the use of the property; even in those instances, there is nevertheless a question whether federal law *should* be interpreted to parallel state law in this respect.[7] In instances in which the automatic stay is eventually lifted or the reorganization effort ultimately fails and the creditor must then proceed under state law, however, the problem is different: a creditor who has already suffered a "foreclosure delay" before obtaining adequate protection in reorganization may suffer another delay of equal duration before he obtains foreclosure proceeds. See *In re Roberts*, 63 Bankr. 372, 381 (Bankr. E.D. Mich. 1986) (expressly rejecting reasoning of decision below for this reason); see also *In re Blackford Farms, Inc.*, 68 Bankr. 639, 642 (Bankr. N.D. Iowa 1986) (recognizing this problem); *In re Mazama Timber Products, Inc.*, 63 Bankr. 280, 287-288 (Bankr. D. Or. 1986) (requiring immediate adequate protection payments but attempting to discern value of property after anticipated 20-month foreclosure delay); *In re Independence Village, Inc.*, 52 Bankr. 715, 730-731 (Bankr. E.D. Mich. 1985); *In re Bear Creek Ministorage, Inc.*,

[7] Arguably, Congress intended—at least with respect to diminution in value of the secured property, if not also with respect to the lost opportunity to reinvest sale proceeds—that creditors receive adequate protection for the entire postpetition period, even though, had bankruptcy not intervened, there would have been delay and the possibility of loss before a foreclosure sale. Pet. 15-16; Am. Council of Life Ins. Br. 12-14; Am. Coll. of Real Estate Lawyers Br. 33-36.

49 Bankr. 454, 458 n.9 (Bankr. S.D. Tex. 1985) (recognizing problem but imposing delay anyway), rev'd on other grounds *sub nom. In re Timbers of Inwood Forest Associates*, 793 F.2d 1380 (5th Cir. 1986) and 808 F.2d 363 (5th Cir. 1978) (en banc), petition for cert. pending, No. 86-1602.[8] The analysis of the court of appeals fails to take account of this important complicating factor.

Nevertheless, this issue does not, in our judgment, warrant review by this Court at this point. The courts of appeals have as yet devoted little attention to the impact of foreclosure delays on adequate protection. Though both subject to the same criticism as the decision below, the other two appellate decisions on point are consistent with the decision below. See *Grundy*, 754 F.2d at 1440-1441; *American Mariner*, 734 F.2d at 435 n.12. In addition, the particular state law that gives rise to the delay in this case, protecting farmers, is rendered less significant by federal legislation changing the Bankruptcy Code, as described below.[9] Accordingly, we suggest that the Court defer consideration of this issue to allow further development in the lower courts.

2. Section 362(d)(2) of the Bankruptcy Code provides for lifting the automatic stay when the debtor has no equity in the property sought to be removed from the stay's protection and that property is not necessary for a

[8] In some cases in which the reorganization fails, the debtor will then go into liquidation under Chapter 7 of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 701 *et seq.* In such cases, the trustee may then have the power under 11 U.S.C. 725 to turn the property over to the secured creditor directly, pretermitting state foreclosure proceedings.

[9] We note, however, that the timing issue arises in contexts other than farm reorganization when either state law or market realities delay foreclosure on real estate. See, *e.g.*, *In re Bessey*, 65 Bankr. 638, 644 (Bankr. S.D. Cal. 1986); *In re Landsea Marketing, Inc.*, 53 Bankr. 436 (Bankr. C.D. Cal. 1985); *In re Woodland Hills Village Development Corp.*, 54 Bankr. 77 (Bankr. D. Md. 1985); *In re Independence Village, Inc.*, 52 Bankr. at 730-731; *In re Bear Creek Ministorage, Inc.*, 49 Bankr. at 457-458 & n.9; *In re South Village, Inc.*, 25 Bankr. at 996 n.14.



successful reorganization. Courts have held that this second requirement is satisfied if the creditor seeking relief from the stay shows that, even with the property the creditor seeks, the debtor could not successfully reorganize. See, *e.g.*, *In re Albany Partners, Ltd.*, 749 F.2d 670, 673 n.7 (11th Cir. 1984); *In re Craghead*, 57 Bankr. 366, 370 (W.D. Mo. 1985). Here, it is undisputed that respondents have no equity in the collateral. Petitioners asserted that they would legitimately object to and block any proposed plan of reorganization and that therefore they should be relieved from the automatic stay.

The Bankruptcy Code provides that a plan can be confirmed over a creditor's objection if the plan is "fair and equitable" to the objecting creditors (11 U.S.C. 1129(b)(1)). If the objecting group of creditors is unsecured,[10] a plan is "fair and equitable" as to them only if they are paid in full (11 U.S.C. 1129(b)(2)(B)(i)) or if no junior interests participate in the reorganization (11 U.S.C. (Supp. III) 1129(b)(2)(B)(ii)). This requirement is the statutory embodiment of the absolute priority rule.[11]

Although the plan that respondents proposed did not meet either of the statutory tests, the court of appeals held that the plan could nevertheless be confirmed. The court read this Court's opinion in *Case* v. *Los Angeles Lumber Products Co.*, *supra*, as allowing participation by

[10] To the extent that petitioners' claims exceeded the value of their collateral, they were entitled to be treated as unsecured creditors (11 U.S.C. 506(a)).

[11] The absolute priority rule has its origins in this Court's decision in *Northern Pacific R.R.* v. *Boyd*, 228 U.S. 482 (1913). There Boyd, an unsecured creditor, had been given no interest in a reorganized firm while the shareholders of the predecessor firm received an interest in it. This Court held that such action violated Boyd's rights. The shares of the new corporation were "a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever" (228 U.S. at 508). In other words, Boyd had an absolute right to be paid in full before any of the equity holders of the former enterprise were allowed to participate in the new one.

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a junior interest even if senior interests are not paid in full, so long as the junior interest "contributes to the reorganization enterprise something that is reasonably compensatory and is measurable" (Pet. App. A24). Respondents had promised to contribute their labor to any reorganized enterprise, and the court held that this promise allowed them to retain an equity interest in their farm up to the value of this promise.

As the dissenting members of the court of appeals recognized, that interpretation of *Los Angeles Lumber* directly conflicts with this Court's opinion in that case. *Los Angeles Lumber* strongly reaffirmed the principle that "'creditors are entitled to priority over stockholders against all the property of an insolvent corporation'" (308 U.S. at 116 (quoting *Kansas City Terminal R.R.* v. *Central Union Trust Co.*, 271 U.S. 445, 455 (1926))). The Court did hold that, at times, it will be "necess[ary to permit] the inclusion of stockholders on payment of contributions, even though the debtor company was insolvent" (308 U.S. at 117). But the Court made it clear that such participation is permissible only when it is *necessary* to preserve going-concern value *and* the interests of creditors are protected. The Court said such participation is permissible only if the old stockholders are the only available source of capital to keep the reorganized corporation operating (*id.* at 117, 121). Even then, the Court was concerned that "the creditor's rights [not] be easily diluted by inadequate contributions by stockholders" (*id.* at 122). Thus, the Court stated (*ibid.*):

> In view of these considerations we believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.[12]

[12] The court of appeals sought to justify its interpretation by relying on the phrase "money's worth" in this passage. It is clear, however, that the full import of this passage is to limit owner equity particiption to cases where the owner has infused the debtor with fresh capital, such as cash or bonds.



The Court illustrated the narrowness of the exception by refusing to apply it to the facts of *Los Angeles Lumber*. The former shareholders argued that their participation in the new corporation was appropriate even though not all creditors were paid in full on the ground, among others, that they were contributing their financial standing in the business community. The Court held that such "intangibles" simply could not be used to overcome the absolute priority rule. "They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities." 308 U.S. at 122-123.

Since *Los Angeles Lumber*, no other court of appeals has suggested that an equity holder can participate in the reorganization of an insolvent debtor without at least contributing new capital that is necessary to the reorganization of the insolvent enterprise. See, *e.g.*, *In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986) ("If [the debtor] were retaining an interest without contributing any capital, the plan would clearly violate the Code."); *In re Potter Material Service, Inc.*, 781 F.2d 99, 101 (7th Cir. 1986) ("An equity-interest owner may retain an interest in the debtor corporation so long as the owner invests new capital into the corporation."); *In re Muskegon Motor Specialties*, 366 F.2d 522, 525 (6th Cir. 1966). Judge Friendly summed up the necessity that old shareholders contribute new capital before participating in a reorganized debtor: "[I]t is hard to see why [the unsecured creditors] should not reap the entire gain if the gamble succeeds, rather than allow the stockholders to have what is essentially a free ride." *SEC* v. *Canandaigua Enterprises Corp.*, 339 F.2d 14, 21 (2d Cir. 1964).

The interpretation of *Los Angeles Lumber* by the court of appeals departed from this common wisdom. The court sanctioned participation of junior interests so long as

they contribute "something that is reasonably compensatory and is measurable" (Pet. App. A24). Thus, the court treated as an acceptable contribution not only capital with present value but the mere promise of future performance, so long as the promise has a determinate value. The court also eliminated the requirement that the contribution be *necessary* to a successful reorganization.[13] Its holding and this Court's previous decisions are in irreconcilable conflict. If the law seems as clear to the Court as it seems to us, the Court may wish to consider summary reversal.

If the Court views the matter otherwise, however, plenary review is unwarranted at this time. Bankruptcy law is in a state of flux. Congress, in response to needs of the family farmer, has recently amended the Bankruptcy Code by adding a special Chapter 12 to deal with the unique problems that confront such debtors. See Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 (1986 Act), Pub. L. No. 99-554, § 255, 100 Stat. 3105-3114. Indeed, the new Chapter 12 appears to be more favorable to farmers than the court's opinion in this case.[14] Under the new

[13] The court of appeals also justified allowing respondents to participate in the reorganization on the grounds that they had "farm operation and management skills" (Pet. App. A24), that their participation would preserve the farm's going-concern value (*id.* at A24-A25), and that "[a]ny other view would deny to most farmers the opportunity to take advantage of the reorganization provisions of the Bankruptcy Act" (*id.* at A25). The first two justifications were expressly disapproved by this Court in *Los Angeles Lumber*. See 308 U.S. at 123 n.16 (approving court of appeals decision not allowing participation based on supposed management skills); *id.* at 123 ("fact that [creditors] might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan [has] no relevant bearing on whether a proposed plan is 'fair and equitable' "). The third merely argues for abrogation of the absolute priority rule.

[14] This new provision, however, appears on its face not to apply to proceedings begun before the effective date of the Act (November 26, 1986). 1986 Act § 302(a) and (c), 100 Stat. 3119. But see *In re Big Dry Angus Ranch, Inc.*, 69 Bankr. 695 (Bankr. D. Mont. 1987) (allowing conversion of pending Chapter 11 case to Chapter 12); *In re Erickson Partnership*, 68 Bankr. 819 (Bankr. D.S.D. 1987) (same).



law, a farmer can retain the equity interest in his land even if unsecured creditors go unpaid so long as the plan provides that the debtor's disposable income for three years is used to make payments under the plan. 100 Stat. 3111 (to be codified at 11 U.S.C. 1225(b)).[15] If, as Judge Gibson thought (Pet. App. A35-A36), the court ignored settled law in order to help the beleaguered farmer,[16] it is quite possible, now that Congress has provided such help, that the judges who supported the decision below will reconsider their position.[17]

Further, the decision of the court of appeals is an aberration. The court clearly departed from settled law. The courts to consider the absolute priority rule after this decision have refused to follow the Eighth Circuit's reasoning. Although the logic of the decision below ex-

[15] The new law has other pro-farmer features. It specifically allows adequate protection only to offset decline in value of the collateral. 100 Stat. 3107-3108 (to be codified at 11 U.S.C. 1205); see also *In re Rennich*, 70 Bankr. 69 (Bankr. D.S.D. 1987). It also dilutes the absolute priority rule as it applies to secured creditors. Compare 11 U.S.C. (Supp. III) 1129(b)(2)(A) with 100 Stat. 3111 (to be codified at 11 U.S.C. 1225(a)(5)). At least one court, however, has suggested that some of the pro-farmer features of Chapter 12, to the extent they are applied retrospectively, may work an unconstitutional taking without just compensation of the property of secured creditors. See *In re* Ray, 70 Bankr. 431 (Bankr. E.D. Mo. 1987).

[16] See also *In re Stegall*, 64 Bankr. 296, 300 (Bankr. C.D. Ill. 1986) ("We understand the motivation behind the majority opinion in *Ahlers*. * * * Nevertheless, the solution [to farmers' plight] proposed by the *Ahlers* majority is contrary to the Bankruptcy Code and a long line of case law.").

[17] If the decision below *were* to be adhered to and followed, however, it could not logically be limited to the farm bankruptcy context. Virtually any debtor in reorganization could claim that his labor, experience, and expertise constitute "money's worth" entitling him to avoid the absolute priority rule, and the rule would be emasculated in farm and nonfarm contexts alike.

tends to any labor-intensive business, one court has read the opinion as only applying to the farm context. See *In re Wolf*, 61 Bankr. 1010, 1012-1013 (Bankr. N.D. Iowa 1986). A second court has rejected its holding outright. See *In re Stegall*, *supra*. Moreover, we doubt that even the Eighth Circuit will adhere to this decision in the long run. Five of the court's 10 judges are on record as regarding the issue as one deserving en banc consideration, and the sixth vote could well be forthcoming the next time the issue comes before the court.[18] Thus, it is quite possible that the only impact of the decision below will be to emasculate the absolute priority rule for purposes of this case. If the Eighth Circuit adheres to this decision in a future case, or another court of appeals follows it, there will be time then for this Court to review the matter.

## CONCLUSION

The Court may wish to consider summary reversal on the absolute priority issue. Otherwise, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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[18] Indeed, petitioners recognize that, "[i]n most situations, this Court might reasonably conclude to allow the Court of Appeals majority to overrule this minority decision in due course" (Pet. 18).

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# SUPPLEMENTAL

# BRIEF

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NO. 86-958

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

NORWEST BANK WORTHINGTON AND FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,

*Respondents.*

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IN THE

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OCTOBER TERM, 1986

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**NO. 86-958**

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NORWEST BANK WORTHINGTON AND FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,

*Respondents.*

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## Supplemental Brief of Petitioners

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Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul submit this supplemental brief pursuant to Supreme Court Rule 22.6, to respond to the Brief for the United States as *Amicus Curiae*.

### SUMMARY

1. After the Solicitor General's brief had been filed, this Court granted certiorari in *In re Timbers of Inwood Forest Associates*, No. 86-1602. As the Solicitor General's brief recognizes, the issues of timing of adequate protection presented in *Ahlers* are related to, but different from, the opportunity cost issue presented in *Timbers*. Since this

Court has decided to consider the adequate protection requirement in *Timbers,* and since the Solicitor General agrees (Brief, pp. 12-14) that the *Ahlers* Court inadequately analyzed its adequate protection issues, Petitioners submit that the Court should grant certiorari in this case as well to permit full presentation of these companion issues affecting administration of the Bankruptcy Code.

2. The Solicitor General's brief recognizes the clear error of *Ahlers* on the absolute priority issue, and suggests (Brief, pp. 10, 18) that the Court may wish to consider summary reversal on that issue. Petitioners obviously would welcome such a reversal; however, summary reversal on the issue of absolute priority alone still would leave undersecured creditors in the Eighth Circuit subject to inadequate protection of their collateral under *Ahlers,* regardless of this Court's ultimate decision in *Timbers.* Accordingly, Petitioners believe that the Court should grant certiorari sideration of these important and interrelated issues of federal law.

## ARGUMENT

### I.

### CERTIORARI SHOULD BE GRANTED TO PERMIT FULL CONSIDERATION OF THE QUESTION OF TIMING OF THE ADEQUATE PROTECTION OBLIGATION UNDER THE BANKRUPTCY CODE.

The Solicitor General's brief recognizes that timing of adequate protection and the double foreclosure delay engendered by *Ahlers* present serious questions (Brief, pp. 12-14), but nonetheless suggests that the Court defer consideration of the issue to allow further development in the



lower courts. However, the Court already has granted certiorari in *Timbers* to resolve the conflict among the circuit courts on the adequate protection issue and the *Ahlers* question of when the obligation to provide adequate protection arises is integral to the Court's analysis of the adequate protection requirement. Because the questions of entitlement and timing go hand in hand, there are obvious efficiencies in considering both questions at this time.

Indeed, the question of timing of adequate protection is arguably of greater significance and more frequent concern than is the *Timbers* issue of whether adequate protection requires compensation for "lost opportunity costs." Adequate protection delayed is adequate protection denied, and may be a taking of property in contravention of the Fifth Amendment to the United States Constitution. *See generally United States v. Security Industrial Bank,* 459 U.S. 70, 75 (1982). As the bankruptcy court in the District of Minnesota has already observed, the decision in *Ahlers* "renders illusory the concept of adequate protection for real estate mortgagees. . . ." *In re Haukos Farms, Inc.,* 68 B.R. 428, 433 n.2 (Bankr. D. Minn. 1986). Whether or not this Court determines in *Timbers* that adequate protection requires compensation for lost opportunity costs will be of little significance to undersecured creditors if the lower courts, as in *Ahlers,* are free to eviscerate the adequate protection obligation by delaying it.

The Solicitor General's brief observes "[a]ll courts agree that, in order to prevent the automatic stay from being lifted, a debtor must protect an undersecured creditor from any decrease over time in the value of the collateral" (Brief, p. 11). The glaring exception to that statement is *Ahlers.* The decision in *Ahlers* is not, as the Solicitor Gen-

eral suggests (Brief, p. 12), merely a limitation on opportunity cost; rather, by delaying the commencement of *any* adequate protection obligation, the decision below provides no protection against decline in the value of the collateral. *Ahlers* thus ignores the fundamental premise of 11 U.S.C. § 361, a premise accepted by every other court that has considered the question of adequate protection.

In view of this Court's grant of certiorari in *Timbers*, the question of timing of adequate protection should also be addressed. The Solicitor General's suggestion (Brief, p. 14) that the timing issue is rendered less significant by the enactment of new farm bankruptcy legislation is inaccurate; the *Ahlers*-imposed delay applies to any collateral subject to redemption or other foreclosure delay, not just farm property. Moreover, it is no answer to say that *Ahlers* is an aberration which the Eighth Circuit will someday correct. In bankruptcy, time is money. Even if a creditor confronted with declining collateral could pursue the question of timing of adequate protection through the lower courts to the court of appeals and ultimately overturn *Ahlers*, the creditor's loss still would be uncompensated and irreparable; by definition the debtor is bankrupt, and the creditor's lost collateral value can never be recovered. In bankruptcy, ultimate vindication of a secured creditor's legal rights cannot restore to the creditor what was lost by the *Ahlers*-imposed delay.

*Timbers* does not raise the issue of timing of adequate protection against loss of collateral value, as opposed to loss of opportunity for reinvestment; *Ahlers* does, and certiorari should be granted to allow determination of that important companion issue along with the issue presented by *Timbers*.



## II.

## IF THE COURT SUMMARILY REVERSES *AHLERS* ON THE ABSOLUTE PRIORITY ISSUE, IT SHOULD ALSO REVERSE AND REMAND FOR RECONSIDERATION OF THE ADEQUATE PROTECTION ISSUES.

The Solicitor General has suggested (Brief, pp. 10, 18) that the Court may wish to consider summary reversal on the absolute priority issue. Petitioners agree with that legal analysis; however, there is concern that reversal on that issue alone would leave intact the *Ahlers* holding on the adequate protection issue, a result which would subject undersecured creditors in the Eighth Circuit to continuing irreparable losses due to delay in requiring any adequate protection.

Therefore, if the Court is inclined to consider summary reversal, Petitioners respectfully request that it reverse and remand on the issue of timing of adequate protection as well.

## CONCLUSION

The *Ahlers* issue of when adequate protection must be provided is inextricably linked to the *Timbers* issue of what interests are entitled to adequate protection. Both questions are significant to the uniform administration of the Bankruptcy Code. Determination of the *Timbers* issue is of little significance without a determination of when the obligation to provide protection arises — delay can be tantamount to denial.

Petitioners respectfully request that their petition for certiorari be granted and that this case be considered with *Timbers* to permit proper consideration of both the timing and nature of adequate protection. Alternatively, in the event that the Court considers summary reversal of *Ahlers*

on the absolute priority issue, Petitioners requests that the Court also reverse and remand for reconsideration of the protection issues.

June 1, 1987

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# AMICUS CURIAE

# BRIEF

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NORWEST BANK WORTHINGTON, and
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v.

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

## BRIEF OF THE AMICUS CURIAE NORTH DAKOTA BANKERS ASSOCIATION IN SUPPORT OF THE PETITIONERS

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## QUESTIONS PRESENTED FOR REVIEW

1. Do the absolute priority provisions of Section 1129 of the Bankruptcy Code (11 U.S.C. § 1129) and this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), prohibit confirmation of a debtor's proposed reorganization plan where (i) the senior interests of unsecured creditors will not be paid in full; (ii) the debtor will retain ownership of property; and (iii) the debtor's only contribution to the plan of reorganization is its non-cash promise to provide future labor, experience and expertise?

The Court of Appeals held "No," reversing the district court and the bankruptcy court.

2. May a bankrupcty debtor use the automatic stay of 11 U.S.C. § 362(a) to retain possession and use of real estate and other collateral subject to a creditor's lien without providing any protection under 11 U.S.C. § 362(d) against decline in the value of the creditor's interest in the property until after expiration of state notice and redemption periods applicable to foreclosure or replevin?

The Court of Appeals held "Yes," reversing the district court and the bankruptcy court.

3. Does 28 U.S.C. § 46(c) require denial of *en banc* rehearing of a two-to-one panel decision where four judges vote to deny rehearing, five judges vote to grant rehearing, and the remaining judge is disqualified and does not vote?

The Court of Appeals denied rehearing on a five-to-four vote in favor of rehearing.

[NOTE: In the event that certiorari is granted as to the above questions, Petitioners reserved the right to

argue the following question 4, but did not include Question 4 among the reasons for the grant of certiorari.]

4. Does a Court of Appeals abuse its discretion in overturning fact findings of the bankruptcy court and the district court regarding lack of adequate protection and unfeasibility of reorganization on the basis of judicial notice of factual matters not presented to the courts below and on the basis of a legal proposition neither presented to the lower courts nor argued in the parties' briefs on appeal?



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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

## BRIEF OF THE AMICUS CURIAE NORTH DAKOTA BANKERS ASSOCIATION IN SUPPORT OF THE PETITIONERS

## INTEREST OF THE AMICUS CURIAE

The North Dakota Bankers Association respectfully submits this brief as *amicus curiae* to urge the Court to grant the petition for a writ of certiorari to review a decision of the United States Court of Appeals for the Eighth Circuit. In that decision the court reversed an order of the District Court affirming orders of the Bankruptcy Court.

The North Dakota Bankers Association is the principal trade association of the commercial banking industry in North Dakota, representing 172 out of the 177 commercial banks in the state. NDBA member banks are located in all but one of the counties with commercial banks in the state of North Dakota and include banks chartered by the Comptroller of the Currency ("national banks") and those chartered by the State Banking Board. The North Dakota Bankers Association occasionally appears in litigation affecting the interests of the banking community as a whole.

Commercial banks are extensively involved in lending to residents and business and agricultural enterprises in the state of North Dakota. In addition to direct loans for agricultural purposes for purchase of real estate, purchase of livestock, and production of crops and other farm products, banks participate with other lenders, including agencies of the U.S. government, in making further loans.

Should the decision of the United States Court of Appeals for the Eighth Circuit in this case stand, the effect could be to inject unnecessary delay in bankruptcy proceedings and effectively deprive lenders of all or part of the security for loans they previously made. This could have a substantial impact on lending practices in all segments of the financial industry, including commercial banks. The likely result would be that the cost of such credit would be substantially increased to partially compensate the lender for the additional risk. There is also the possibility that many potential borrowers, especially in the agricultural sector, would not receive any loans, thus possibly being forced out of business.



Accordingly, the North Dakota Bankers Association, with the consent of the parties, filed herewith under Rule 36, respectfully submits this brief as amicus curiae in order to represent the interests of its members.

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## ARGUMENT

The North Dakota Bankers Association, as *amicus curiae*, supports the Federal Land Bank and Norwest Bank Worthington on their Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit for the decision rendered in *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986). In addition to the instant case, this ruling, if it stands, would have a far reaching effect on bankruptcies and lending.

Judge Gibson, in his dissent at page 404 of *In re Ahlers*, summed it up very well when he stated:

> "Understandably sympathetic in the face of admittedly acute difficulties gripping the nation's entire farm economy, the court unabashedly legislates a result which undermines reasonable commercial expectations, and substantially reorders the risks of insolvency borne by farm debtors and their bankers."

He concludes his dissent, at page 408, with:

> "It is only through the court's disregard of its proper role that it can coax from the record, and from sources outside the record, its conclusion that a razor thin margin might exist by which Ahlers could feasibly reorganize. If there is to be an adjustment to the relationship between the farmer and the farmer's bank, serious policy questions are presented which

can best be considered by the Congress. We, however, are advised to confine our efforts to deciding cases on the law as written and on the facts as found."

The ruling in this case definitely breaks new ground in bankruptcy matters. Unfortunately, this appears to be contrary to the bankruptcy law as codified in statute and interpreted by the courts of this country. It is obviously unfair to lenders who entered into a relationship with a borrower based on long standing bankruptcy practice. Now the Eighth Circuit attempts to change the rules of the game in midstream.

The lenders made the loans and took certain collateral as security, based on current understanding of the law. Now, there is a change in the law, which makes it more difficult for the lenders to either obtain the collateral or be given adequate protection.

This action of the Court only appears to add further serious delay to already drawn out bankruptcy proceedings. There is adequate delay built into the current system without expanding it for no good reason.

If this decision is carried to its ultimate conclusion, no bankruptcy plan would ever be rejected or terminated for being unsuccessful. There is always that "light at the end of the tunnel" for the bankrupt. Reason dictates that sometimes common sense should prevail and a determination be made that every little dim glimmer of light should not be pursued. Everyone "can make it." But, how many of them actually do? We cannot have a complete breakdown of the system just on the chance that one might. There has to be an end sometime! Delay only increases the cost for those borrowers who pay their debts



and lowers the return to those financial institution depositors whose money is being lent to the borrower.

## CONCLUSION

For all of the reasons stated herein, the North Dakota Bankers Association, as *amicus curiae*, on behalf of its member banks, hereby respectfully urges the court to grant the Petition for a Writ of Certiorari.

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# AMICUS CURIAE

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*Petitioners,*

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

## BRIEF OF THE STATES OF ARKANSAS, IOWA, MINNESOTA, MISSOURI, NEBRASKA, NORTH DAKOTA AND SOUTH DAKOTA IN OPPOSITION TO THE JOINT PETITION FOR A WRIT OF CERTIORARI.

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IN THE

# Supreme Court of the United States

October Term, 1986

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NORWEST BANK WORTHINGTON and FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

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**BRIEF OF THE STATES OF ARKANSAS, IOWA, MINNESOTA, MISSOURI, NEBRASKA, NORTH DAKOTA AND SOUTH DAKOTA IN OPPOSITION TO THE JOINT PETITION FOR A WRIT OF CERTIORARI.**

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## STATEMENT OF INTEREST

The issues in the present case are raised in the context of a national crisis in agriculture. As of January, 1986, over forty-eight percent (48%) of all United States farms were experiencing a negative or zero cash flow. Economic Research Service, U.S. Dep't of Agric., Agric. Info. Bull. No. 500, *Financial Characteristics of U.S. Farms, January 1, 1986*, 8. Upper Midwest farmers' earnings and farm land values have declined and, to date, this decline continues. *Agricultural Credit Conditions Survey*, 3rd Quarter 1986, Federal Reserve Bank of Minneapolis, Minnesota. Accordingly, the issues before the court in the present case are of considerable public importance.

Each of the amici states that join in this brief have a citizenry substantially affected by the agricultural economy. For example, in Minnesota, farming and farm-related industries constitute approximately twenty-five (25%) percent of that state's economic base, with nineteen (19%) percent of Minnesota's jobs directly or indirectly related to farming. Interview with Professor Wilbur R. Maki, Department of Agricultural and Applied Economics, University of Minnesota (May 2, 1986). In each of the amici states, agriculture is a substantial industry that forms both an integral part of that state's economy and social fabric.

Because of the importance of agriculture in each of the amici states, the problems which presently plague rural citizens are a major public concern. Not only are farms and farm families at risk, all of rural society as it now exists is threatened. As Professor Neil E. Harl has stated,

> "Unless something dramatic is done or circumstances change, more than one-third of the farmers nationally will move to insolvency within three to four years, taking down their lenders, their suppliers, and other merchants and inflicting incalculable damage upon the fabric of rural communities. Discharged indebtedness will ricochet through local communities, with the unsecured creditors taking the greatest hit."

Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 Kan. L.Rev. 425, 430 (1986).

In response to this situation, the states have considered various forms of farm debt-relief statutes. In Minnesota, for example, the legislature passed such legislation based upon the following findings:



> The legislature finds that the agricultural sector of the state's economy is under severe financial stress due to low farm commodity prices, continued high interest rates, and reduced net farm income. The suffering agricultural economy adversely affects economic conditions for all other businesses in rural communities as well. Thousands of this state's farmers are unable to meet current payments of interest and principal payable on mortgages and other loan and land contracts and are threatened with the loss of their farmland, equipment, crops, and livestock through mortgage and lien foreclosures, cancellation of contracts for deed, and other collection actions. The agricultural economic emergency requires an orderly process with state assistance to adjust agricultural indebtedness to prevent civil unrest and to preserve the general welfare and fiscal integrity of the state.

Minn. State. Sec. 583.21 (1986).

In addition to the relief that the states have attempted to provide for their rural citizenry, many farmers have turned to the Bankruptcy Code in an effort to resolve their financial distress. It is in this context that the present debtors, Mr. and Mrs. Ahlers, seek reorganization of their family farm enterprise. The issues addressed in their case concern not only whether such reorganizations will be available to them, but whether such reorganizations will be available for thousands of others like them throughout the several amici states. According to the interpretation of the Bankruptcy Code espoused by Petitioners, such reorganizations would be effectively eliminated. Under the guidelines set forth in the decision of the Eighth Circuit Court of Appeals of July 2, 1986, the debtors and similarly situated farm operators

would be afforded the opportunities for reorganization intended by Congress when it enacted the Bankruptcy Reform Act of 1978. For these reasons, the amici states respectfully offer this brief in opposition to the Joint Petition for a Writ of Certiorari.





## SUMMARY OF ARGUMENT

Section 362(d) of the Bankruptcy Code provides that in certain situations a creditor may obtain relief from the automatic stay imposed by that section if its interest in the debtor's property is not adequately protected. In attempting to strike a balance between the interests of reorganizing debtors and their secured creditors, certain courts have construed the adequate protection requirements to include payment to a creditor of its "lost opportunity costs." Since the nature and extent of a secured creditor's interest in collateral is determined under state law, any payments for lost opportunities must be based upon actual lost opportunities, taking into account any delays that are imposed by state law. In this regard, the decision of the Eighth Circuit Court of Appeals is completely consistent with existing case law as it interprets both the Bankruptcy Code and applicable state law.

While the Bankruptcy Code's absolute priority rule appears to set forth in almost insurmountable barrier to the reorganization of small businesses, including family farmers, courts, including the Supreme Court, have fashioned a more realistic and practical rule. The decision of the Eighth Circuit Court of Appeals is consistent with such a reading of the Bankruptcy Code, particularly in light of the clear history of the rule.

## ARGUMENT

### I.

### A SECURED CREDITOR IS NOT ENTITLED TO COMPENSATION FOR "LOST OPPORTUNITY COSTS" UNTIL SUCH TIME AS IT HAS SUSTAINED SUCH A LOSS.

When a bankruptcy case is commenced, 11 U.S.C. Sec. 362 provides for an automatic stay, designed to give the debtor "a breathing spell from his creditors . . . [to permit] the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." H.R. Rep. No. 595 95th Cong. 2nd Sess. 340, reprinted in 1978 U.S. Code Cong. & Ad. News 6296-97. The impact of this stay, however, is tempered by various creditor safeguards built into the Code, including the right to adequate protection, which is specifically set forth in Sec. 362(d). These rights replace the protection afforded a creditor by possession. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 207 (1983). By providing a creditor with a means of protecting its interest through the adequate protection requirement, the competing interests of the debtor's need to reorganize and the secured creditors' entitlement to protection of its bargained-for property interest are reconciled. *In Re Briggs Transportation Co.*, 780 F.2d 1339, 1342 (8th Cir. 1985). As such, adequate protection is a safeguard which balances the rights of secured creditors with the rights of the debtor.

The phrase "adequate protection of an interest in property" as set forth in Sec. 362(d) is not defined within the Code. Section 361, however, lists three means by which such protection can be provided. According to this section, a debtor may make cash payments or provide additional or



replacement liens to compensate the creditor for a decrease in the value of its interest. As a third means, the creditor may be granted relief which is the "indubitable equivalent" of its interest in the property.

Nowhere in the Code is there specific reference to the lost opportunity costs at issue in the present case. Similarly, the legislative history behind Sec. 361 reveals that throughout the in-depth hearings before the House and Senate, lost opportunity costs were never even discussed. Rather, this category of adequate protection is a judicial creation formalized by the Ninth Circuit decision, *In Re American Mariner Industries, Inc.*, 734 F.2d 426 (9th Cir., 1984), based upon the indubitable equivalence prong of Section 361. According to *American Mariner*, this alternative protects the creditor's present interest in its collateral and its right to take possession of it pursuant to state law. Under *American Mariner*, adequate protection must be provided if this present interest is hampered. The creditor is thus awarded lost opportunity costs for its inability to take possession of the collateral, sell it, and reinvest the proceeds. In effect, the creditor is awarded post-petition interest payments for the debtor's continued possession of the collateral and the creditor's lost investment opportunities.

Only three other Courts of Appeals have addressed the specific issue of lost opportunity costs. The Fifth Circuit recently rejected the *American Mariner* interpretation in a panel decision, although this decision is being reviewed en banc. *In Re Timbers of Inwood Forest Associates, Ltd.*, 793 F.2d 1380 (5th Cir., 1986). In the Fourth Circuit, the Court of Appeals accepted the *American Mariner* concept of lost opportunity costs, but modified the timing of the entitlement. *Grundy National Bank v. Tandem Mining Cor-*

*poration*, 754 F.2d 1436 (4th Cir., 1985). Similarly, the Eighth Circuit in *In Re Briggs Transportation Co.*, 780 F.2d 1339 (8th Cir., 1985), limited *American Mariner* by holding that an undersecured creditor's claim to lost opportunity costs must be determined on a case by case basis. The present case further refines *Briggs* by addressing the timing of such lost opportunity cost payments.

In summary, although the Code is clear with regard to adequate protection payments for a decline in the value of a creditor's collateral, the payment for lost opportunity of investment of collateral proceeds is a separate matter. The court's decision in the present case does not deny the creditors adequate protection for a decline in the value of their collateral. Rather, the decision concerns only the lost opportunity costs which may be due to them. (A. p. 12). Specifically, it focuses on the actual opportunities available to the creditors and the timing of any loss.

In determining whether a creditor is entitled to adequate protection under Sec. 362(d), it is, of course, necessary to determine whether that creditor has an interest in the debtor's property and the extent of that interest. On this issue, the law is clear that the applicable state law is determinative. For example, in *Butner v. United States*, 440 U.S. 48 (1979), it was held that the extent of a secured creditor's interest in rents collected during the period between a mortgagor's bankruptcy, and the subsequent foreclosure sale of the mortgaged property, was to be determined by state law:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.



*Butner*, 440 U.S. at 55. The Court also observed that "[u]niform treatment of property interests by both state and federal courts within a state serves . . . to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" *Butner*, 440 U.S. at 55 (quoting *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609 (1961)). The *American Mariner* court recognized and accepted this proposition as the point of beginning of its analysis. *American Mariner, supra*, 734 F.2d at 435. *See, also, Johnson vs. First National Bank of Montevideo*, 719 F.2d 270, 276 (8th Cir. 1983), cert. denied, 104 S.Ct. 1015, (1984), and *In Re Davison*, 738 F.2d 931 (8th Cir. 1984).

Applying the *Butner* rule to the issue in the present case, the court properly looked to Minnesota law to determine the nature and extent of the creditors' interests. Under this law, a mortgage of real property is not a conveyance which enables the holder of the mortgage to recover possession of the real property without completion of the foreclosure procedures established by state law. Minn. Stat. Sec. 559.17, subd. 1 (1982). This statute and its predecessors have long been interpreted to mean that during the period of redemption allowed by Minnesota Statutes Sec. 580.23 and Sec. 581.10, the mortgagor retains all rights of ownership, including the right to possession and the right to profits. *Ewert v. Anderson*, 359 N.W.2d 293 (Minn. App. 1984); *Woodmen of World Life Insurance Society v. Sears Roebuck & Co.*, 200 N.W.2d 181 (Minn. 1972); *Johnson*, 719 F.2d at 276. In addition, Minnesota law provides that any assignment of rents and profits from mortgaged real property by the mortgagor as additional security for the debts secured by the mortgage, is unenforceable unless the assign-

ment secures an original principal amount of $500,000.00 or more; was executed, modified, or amended subsequent to August 1, 1977; and is not a lien on property which was entirely homesteaded as agricultural property. Minn. Stat. Sec. 559.17, subd. 2 (1982). As a result, in the present case, under Minnesota law, neither Norwest nor FLB could obtain possession, or derive any income from the mortgaged real property, until they had provided the mortgagors with six weeks' published notice, Minn. Stat. Sec. 580.03 (1982), and the redemption period of 12 months had expired. Minn. Stat. Sec. 580.23, subd. 2 (1982). At the time that the present action was initiated, neither creditor had any right to the possession of or profits from the property. No opportunity for investment has been lost by virtue of the bankruptcy filing. As a result, any award of lost opportunity costs would be "a windfall [to the creditor] merely by reason of the happenstance of bankruptcy." *Butner*, 440 U.S. at 55.

This reasoning is totally consistent with that of *American Mariner*. As that court stated:

> There are a few general guidelines that the trial court and debtor should consider. First, to avoid overcompensating the secured creditor, the timing of adequate protection should take account of the usual time and expense involved in repossession and sale of collateral.

*American Mariner*, 734 F.2d at 435, n. 12.

This approach was also accepted by the Fourth Circuit in *Grundy* which stated that the "timing of interest should be postponed to take account of the time that would be consumed in repossession and sale of the collateral." *Grundy*, 754 F.2d at 1441.



Based upon this reliance upon state foreclosure law, it is important to note that although North Dakota has provisions very similar to Minnesota, N.D. Cert. Code Sections 28-24-01, 02 (1976), other states have not necessarily extended the foreclosure process as far as have Minnesota and North Dakota. For example, in Missouri, the most common security instrument is the deed of trust. B. Dunaway, *The Law of Distressed Real Estate*, 9-5 (1986). Under Missouri law, a foreclosure sale may be held upon twenty days' notice. Mo. Ann. Stat. 443.310 (1982). No redemption is allowed under Missouri law unless the mortgagor provides security for the payment of interest, foreclosure costs, taxes, and any protective advances made by the purchaser at the foreclosure sale. Mo. Ann. Stat. 443.420 (1982). In Arkansas, where property is sold non-judicially under a power of sale, the mortgagor may redeem within one year of the sale. Ark. Stat. Ann. Sec. 51-1112 (1971). Property may be redeemed from a judicial sale as well, however, this right can be waived. It is general practice to provide a waiver. Dunaway, *supra*, at 15-7.

Since state law is the beginning point in any analysis under Sec. 362, the effect of the court's decision on a debtor's obligation to provide adequate protection will vary from state to state. As with the case of post-petition rents, the primary reason why a holder of a mortgage may fail to be provided post-petition interest during any foreclosure delays must stem from state law. This is wholly in keeping with the concept that the creditor is entitled to the interest that he bargained for — an interest governed by the state law under which it is created.

Finally, the court's decision is consistent with the *American Mariner* analysis and the provisions of the Bankruptcy

Code relating the the "value" of the secured creditor's interest in property of the estate. While Sec. 361 may be directed toward the value of the protected entity's interest in the property involved, the section "does not specifiy how value is to be determined, nor does it specify when it is to be determined." H.R. Rep. No. 595, 95th Cong., 2nd Sess. 339, reprinted in 1978 U.S. Code Cong. & Ad. News at 6295. Congress clearly left the method and timing of valuation open ended. Such issues are to be accomplished according to the "equitable considerations" of each case. *Id.*

Since the "lost opportunity cost" analysis of *American Mariner* posits a liquidation of the property and reinvestment of the proceeds, it is completely consistent with such an analysis to defer the determination of valuation and the beginning of lost opportunity payments until that date at which a secured creditor, absent a bankruptcy filing, could achieve such results.

If the debtor successfully reorganizes, or if the collateral appreciates in value during the period between the commencement of the bankruptcy case and the date at which a plan of reorganization is confirmed ,the secured creditor will not be adversely affected by the holding of the court. If, however, the debtor is not successful, the court's decision may have resulted in inadequate protection. In either case, the creditor is confronted with the same risk as presented by the redemption period absent a bankruptcy filing.

Moreover, a secured creditor is provided with numerous other devices which may be used to protect its position during the period between the commencement of a bankruptcy case and plan confirmation. A creditor may move the Bankruptcy Court to dismiss the case if a debtor is dilatory. 11 U.S.C. Sec. 1112(b)(3). A creditor may ask



the court to appoint a trustee or examiner if the court finds it appropriate. 11 U.S.C. Sec. 1104; *See, e.g., In Re John Peterson Motors, Inc.*, 47 Bankr. Rep. 551 Bankr., D. Minn. 1985). Furthermore, the debtor's exclusive right to file a plan is limited to 120 days, 11 U.S.C. Sec. 1121(b), unless extended "for cause." 11 U.S.C. Sec. 1121(d). Such extensions may be difficult to obtain. *See, e.g., In re Tony Downs Foods Co.*, 34 Bankr. Rep. 405 (Bankr., D. Minn. 1983). If the debtor does not file a plan within this time period, or does not obtain an extension of the period of exclusivity provided by Sec. 1121(d), a creditor may file a plan of its own. 11 U.S.C. Sec. 1121(c)(2). Such a plan may provide for a sale of all or any part of the property of the estate, or the distribution of all or any part of the property of the estate among those having an interest in such property. 11 U.S.C. Sec 1123(a)(5)(D). *See also* 11 U.S.C. Sec. 1123(b)(4). Such a liquidation plan may be confirmed over the objection of a farm debtor, notwithstanding the provisions of 11 U.S.C. Sec. 303(a) and Sec. 1112(c). *Matter of Button Hook Cattle Co., Inc.*, 747 F.2d 483 (8th Cir. 1984), and *Matter of Cassidy Land and Cattle Co., Inc.*, 747 F.2d 487 (8th Cir. 1984). Because secured creditors maintain such rights, the equilibrium of interests in the reorganization process has not been disturbed by the court's decision.

Petitioners' contentions are, on final analysis, based upon state law. They point to the delays imposed upon the exercise of their right to possess the property and on that basis request compensation for their "lost opportunities." As has been shown, however, such delays are provided by some, but not all, state legislatures. Accordingly, such concerns are more appropriately addressed to such bodies. It is not appropriate to seek an exemption from such state

laws under the guise of adequate protection. Finally, secured creditors have several other means of protecting their interests. Post-petition interest payments, lost opportunity costs, are not the exclusive method of protecting such interests.

## II.

## THE "ABSOLUTE PRIORITY RULE" DOES NOT PROHIBIT CONFIRMATION OF A PLAN OF REORGANIZATION UNDER WHICH AN INDIVIDUAL DEBTOR WILL RETAIN CONTROL OF THE BUSINESS ASSETS OVER THE DISSENT OF UNSECURED CREDITORS WHERE SUCH CREDITORS ARE PAID IN FULL.

The court's decision provides that unsecured creditors cannot prevent a Chapter 11 plan of reorganization from being approved on the basis of the "absolute priority rule" if (1) the plan of reorganization provides for the payment of unsecured claims in full, and (2) the individual debtor agrees to contribute his experience, knowledge, and labor to the successful implementation of the plan. Petitioners contend in their joint petition for certiorari that such a plan would violate the "absolute priority" rule of the Bankruptcy Code and as a result, may not be confirmed.

The absolute priority rule of the Bankruptcy Code with respect to a class of unsecured creditors, including the unsecured portion of an undersecured creditor's claim (after application of 11 U.S.C. Sec. 506(a)), is found in 11 U.S.C. Sec. 1129(b)(2)(B)(ii). That section provides as follows:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:



> (B) With respect to a class of unsecured claims —
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

Sections 1129(b)(2)(A) and (C) provide separate and distinct absolute priority rules for secured claims and equity interests. Under the Code, a plan of reorganization must satisfy this absolute priority rule as to any class of impaired unsecured claims that does not accept the plan. 11 U.S.C. Sec. 1129(a)(8); 11 U.S.C. Sec. 1129(b)(1).

At first glance, it would appear that this rule would totally prohibit any plan of reorganization propounded by proprietors such as the debtors unless (1) the class of unsecured creditors accepted the plan, 11 U.S.C. Sec. 1129(a)(8)(A); (2) the class was not impaired under the plan, 11 U.S.C. Sec. 1129(a)(8)(B); or (3) the individual debtors did not retain any interest in nonexempt property under the plan, 11 U.S.C. Sec. 1129(b)(2)(B)(ii).

However, despite the apparently complete prohibition of the Code against any junior class retaining "any property," several cases decided under the Code have allowed participation in the reorganized enterprise by former stockholders of a corporate debtor.

In *In Re Brown's Industrial Uniforms*, 58 Bankr. Rep. 139 (Bankr. N.D. Ill. 1985) the District Court affirmed the confirmation of a plan of reorganization under which the shareholder of the corporate debtor retained his interest in the reorganized company and agreed to use his personal assets as security in order to obtain additional working capital. *In Matter of U.S. Truck Company, Inc.*, 47 Bankr.

Rep. 932 (Bankr. E.D. Mich. 1985), the District Court confirmed a plan under which the shareholder of the corporate debtor purchased all the stock of the reorganized corporation despite the objection of unsecured creditors. Finally, in *In Re Potter Material Service, Inc.*, 781 F.2d 99 (7th Cir., 1986), the Seventh Circuit Court of Appeals affirmed confirmation of a plan over the objection of the unsecured creditors under which the president and sole shareholder of the corporation retained his equity interest in the corporation in exchange for contributing $14,800 to fund a 3% repayment to the objecting creditors, paying the debtor's allowed attorneys fees of approximately $20,000, and renewing a personal guaranty of the debtor's liability on a $600,000 note. Even though the shareholder was already personally liable for the debt, the bank promised no new capital contribution to the debtor, the debt was already oversecured by $98,000, and the shareholder failed to present any evidence that he had personal assets which the secured creditor could apply against the guaranty, the Bankruptcy Court and District Court both found that the shareholder's renewal of the personal guaranty was "an economic risk of indeterminable value and thus consideration toward the purchase of [the debtor's] stock." *Id.*, at 103.

These cases all involve plans under which equity shareholders were allowed to retain their interest in the reorganized business without payment in full of all senior classes despite the compelling language of 11 U.S.C. Section 1129(b)(2)(B)(ii).The courts uniformly looked behind the statutory language to the traditional absolute priority rule, and the exceptions created by courts prior to enactment of the Code in ascertaining the meaning of the rule under the Code. Accordingly, the traditional absolute



priority rule is the beginning point in any analysis of the rule under the Bankruptcy Code.

The absolute priority rule was developed to prevent stockholders of an insolvent corporation from participating in a reorganization while some creditors remained unpaid. This could be done by having the corporation put itself into a "friendly" receivership, under an agreement with major creditors that stockholders would participate in the reorganized corporation. The major creditors, able to bid their claims instead of cash, were usually able to purchase at a low price. Frequently, there would be little or nothing left for distribution to general creditors. The shareholders of the old corporation would, therefore, become shareholders of the new corporation, which was free of all the old debt. *See* 6 *Collier on Bankruptcy*, par. 0.04 (14th Ed. 1978).

Such manipulations were ruled out by the absolute rule of priority that a stockholder's interest in the reorganizing business is subordinate to the rights of creditors. *Louisville Trust Co. vs. Louisville Railway Co.*, 174 U.S. 674 (1899). The rule was applied to equity receiverships in *Northern Pacific Railway Co. vs. Boyd*, 228 U.S. 482 (1913); to Section 77B of the Bankruptcy Act in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) and later, to Chapter X in *Consolidated Rock Products v. DuBois*, 312 U.S. 510 (1941). In *Case vs. Los Angeles Lumber Products Co.*, Justice Douglas recognized that the Rule was incorporated as a result of the requirement that any plan of reorganization be "fair and equitable." 308 U.S. 106 at 115.

This "fixed principle" was modified, by however, in *Case v. Los Angeles Lumber Products Co.* There, it was recog-

nized that, although an equity security holder could not retain his interest, it could participate in the reorganized corporation by providing new consideration. The court stated:

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court, as we have seen, indicated as much in *Northern Pacific Railway Co. v. Boyd*, supra, and *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, supra. Especially in the latter case did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

308 U.S. 106 at 121.

Such an exception was based upon "practical considerations," since, in some cases, only the former shareholders would be willing to supply essential operating funds, and such shareholders would not be willing to do so unless they were allowed to retain an interest in the reorganized company. *See, Los Angeles Lumber Products Co.*, 308 U.S. at 117.

While the *Los Angeles Lumber Products* case recognized an exception to the absolute priority rule which allowed shareholder participation in the reorganized business when based upon "a contribution in money or moneys worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder," the Court found that, on the facts presented, continuity of management and



"financial standing and influence in the community" were "no legal justification for issuance of new stock" to the shareholders. 308 U.S. at 122. However, the stockholder participation in the reorganized company there was not limited to those stockholders who were actually a part of the management. 308 U.S. at 123, n. 17. In addition, the plan did not insure continuance of the old management group, for there was no contractual commitment by the shareholders who may have been previously contributing to the management to remain in that capacity. Indeed, the District Court had merely found that the existing management had "expressed a willingness to assume managerial responsibility." *In Re Los Angeles Lumber Products Co.*, 24 F. Supp. 501, 513 (S.D. Cal., 1938). Based upon the record before it, the Supreme Court concluded that such promises of future services "reflect merely vague hopes or possibilities. As such they cannot be the basis for issuance of stock to otherwise valueless interests." 308 U.S. at 123.

While *Case vs. Los Angeles Lumber Products Co.*, involved the application of the "fair and equitable" rule of Sec. 77B(f)(1) of the Bankruptcy Act of 1898, Congress had, in 1938, enacted the Chandler Act, 52 Stat. 840 (1938), which amended the Bankruptcy Act and added Chapters X, XI, and XII. Chapter X provided relief for corporations, as did Sec. 77B. Relief under Chapter XI was available to individuals as well as corporations, and was intended to permit smaller businesses to negotiate compositions with their unsecured creditors. Chapter XII provided for real property arrangements by persons other than corporations. The requirement that a plan be "fair and equitable" was carried forward into Chapters X and XI. 11 U.S.C. Sec. 364, 621 (1938). The issue thus arose as

to whether the words "fair and equitable" with respect to the relationship between creditors and stockholders of a publically-held corporation had the same meaning in Chapter XI cases including closely-held corporations or non-corporate debtors.

The rule stated in the *Los Angeles Lumber Products* case as applied to such businesses was soundly criticized in Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine,* 45 Colum. L.Rev. 739 (1945). There. it was observed that the *Los Angeles Lumber Products* rule would prove to be fatal to any business composition in cases where ownership and management were substantially identical except in those cases where creditors unanimously agreed to accept less than full compensatory treatment. *Id.* at 741, n. 8. The result, "can only result in an increased number of liquidations and losses to creditors, particularly in the case of small business units." *Id.* at 744.

*In Horowitz v. Kaplan,* 193 F.2d 64 (1st Cir., 1951) *cert. den* 342 U.S.946 (1952) the First Circuit Court of Appeals upheld the confirmation of a plan of reorganization under Chapter X of the Bankruptcy Act which allowed the management an option to eventually acquire 32% of the common stock of the corporate debtor. The plan was challenged by certain other shareholders as being in contravention of the absolute priority rule. In responding to such contentions, the court rejected the argument that the *Los Angeles Lumber Products Co.* case established a "rigid rule of such wide application as to forbid the type of reorganization proposed under the circumstances of the present case." *Horowitz,* 193 F.2d at 74. The court further found that the



two managers' skills were "deemed to be an important assurance of [the debtor's] future success." *Id.* at 75. Finally, the court concluded, "We do not believe that Congress, in enacting Chapter X, intended to preclude the possibility of including such sensible business arrangements as part of a plan of reorganization." *Id.*

In 1952, Congress amended Section 366 of the Bankruptcy Act to elinimiate the requirement that an arrangement under Chapter XI be fair and equitable. 66 Stat. 433, Sec. 35 (1952). Similar amendments were made to Chapter XII and Chapter XIII. 66 Stat. 433, Sections 43, 50 (1952). In addition, Congress added a sentence at the end of Section 366 which states:

> Confirmation of an arrangement shall not be refused solely because the interest of a debtor, or if the debtor is a corporation, the interests of its stockholders or members will be preserved under the arrangement.

66 Stat. 433, Sec. 35 (1952). Similar language was also included in Section 472 of Chapter XII and Section 656(a) of Chapter XIII.

In enacting the amendments to the Bankruptcy Act in 1952 Congress was concerned with the application of the absolute priority rule in Chapters XI, XII and XIII to individuals and business organizations where the management and the holders of the equitable interests were substantially similar. In expressing the Congressional intent behind eliminating the "fair and equitable" confirmation standard the House Committee Report indicates:

> [T]he fair and equitable rule, as interpreted in *Northern Pacific Railway Co. v. Boyd,* and *Case v. Los Angeles Lumber Products Co., Ltd.,* cannot be

> realistically applied in a Chapter XI, XII or XIII proceeding. Where it so applied, no individual debtor and, under Chapter XI, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payments of the claims of all creditors in full.
> The proposed amendment is designed to remove the fair and equitable provision, and by the paragraph added to each of the amended sections it is made clear that the rule of the *Boyd* and *Los Angeles* cases shall not be operative under those three Chapters.

House Rep. No. 2320, June 26, 1952, 82nd Cong., 2d Sess., 2, reprinted in 1952 U.S. Code Cong. & Ad. News 1981-1982 (Citations omitted).

The Senate legislative history contains a similar explanation:

> The language "fair and equitable" was derived from Section 221(2) of Chapter X, in which, for the purposes of a corporate reorganization, the requirement is sound and necessary. However, the fair and equitable rule cannot be applied in a Chapter XI, XII, or XIII proceeding, if construed as interpreted in *Northern Pacific Railway Co. v. Boyd*, and reaffirmed in *Case v. Los Angeles Lumber Products Co., Ltd.*, without impairing if not entirely making valueless the relief provided by these chapters. If so applied, no individual debtor or corporate debtor (where stock interests are the same as management) would be eligible for relief.

Senate Rep. No. 1395, April 2, 1952, 82nd Cong., 2d Sess., 11-12 (citations omitted).

Congress was thus very clear. The absolute priority rule was henceforth to be applicable only to corporate reorganizations under Chapter X of the Bankruptcy Act. It was not to be applied to Chapter XI, XII, or XIII compositions or arrangements which could be proposed by either individuals, partnerships or closely held corporations. This was the law from the enactment of the 1952 amendments until adoption of the Bankruptcy Reform Act of 1978.



The Bankruptcy Reform Act of 1978 consolidated Chapters X, XI, and XII into a single chapter, Chapter 11. The motivating factor behind this consolidation, at least with respect to the "fair and equitable" test, was to prevent large corporations from avoiding application of the absolute priority rule as they had been able to do under the Act by filing under Chapter XI. House Rep. No. 95-595, 95th Cong., 2d Sess. 222-224. However, a review of the extensive legislative history of the Bankruptcy Code does not reveal a single reference, by testimony or report, to the reinstatement of the absolute priority rule to a plan propounded by a sole proprietor. There is no indication whether the interpretation given to the phrase "fair and equitable" in *Case vs. Los Angeles Lumber Products Co.*, is intended to be applied to such cases. Indeed, it is only open to speculation as to whether Congress even considered application of the rule to proprietors. And there is most certainly no unequivocal expression of Congressional intent as with the 1952 amendments to the Bankruptcy Act. Thus, when considered in light of the legislative history, and the history of the traditional rule of absolute priority the true meaning of 11 U.S.C. Sec. 1129(b)(2)(B)(ii) is doubtful.[1]

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[1]It should be noted that Congress has recently provided for the reorganization of farming operations such as involved here. There is no requirement that a plan under Chapter 12 be "fair and equitable." 11 U.S.C. 1225 (1986).

It is against this background that the court's decision must be assessed. The court's decision merely provides that, in assessing whether a plan of reorganization submitted by a farm operator under which the operator will retain ownership of the farm assets, a bankruptcy court must consider the value of the farmer's labor and management skills. Such contributions may, in appropriate cases, be sufficient to allow confirmation of such a plan over the objection of an impaired class of unsecured creditors. Such a holding recognizes that labor and management skills are significant factors which distinguish the liquidation value of a farm business from the "going concern" value of the same business. In the case of a small business unit, such factors are frequently the basis for a creditor's decision to give up value in order to maintain the existing management as a part of a business workout arrangement.

Such an evaluation may, of course, reveal that creditors would realize more in an immediate liquidation than in the continued operation of the farming enterprises. In such cases, the farm operator's labor and management contributions will not exceed the value of the retained equity interest. And, in such cases, the court's decision does not mandate the confirmation of the debtor's plan of reorganization. The Bankruptcy Court must also assess whether the proposed plan is feasible, 11 U.S.C. Sec. 1129(a)(11), and whether the creditors would receive no less than the amount that they would receive if the debtor were liquidated under Chapter 7. 11 U.S.C. Sec. 1129(a)(7).

Finally, the court's decision requires that any income from the debtors' continued operation of the farm in excess of that anticipated in the plan be paid to unsecured creditors on a pro rata basis until such time as the unsecured creditors



are paid in full without interest. (A. pp. 2-3; 27). In other words, it is only *after* their creditors are paid in full that the debtors will enjoy the fruits of their labors.[2] Petitioners, on the other hand, desire to liquidate such farming operations despite the restrictions of the court's decision and before the debtors have had an opportunity to reorganize. They claim precisely the ability to veto a debtor's reorganization efforts that was rejected by Congress in 1952. Such a position ignores the central purpose of Chapter 11 and renders it valueless to family farmers such as the Respondents. Such a result cannot be the intent of Congress.

## CONCLUSION

The decision of the Eighth Circuit Court of Appeals further refines and clarifies the standard for payment of postpetition interest announced by that court in *Briggs Transportation*. It is completely consistent with existing case law, including *American Mariner*. The decision is similarly in accord with both historical and contemporary statements of Congressional intent with respect to the application of the absolute priority rule of the Bankruptcy Code. That rule was never intended to grant unsecured creditors a veto power over an attempted reorganization by a family

---

[2]A similar provision is found in Section 1225(b)(1)(B), recently enacted by Congress. However, under Chapter 12, a family farmer need only pay such "disposable income" to his creditors during the duration of the plan, which is limited to five (5) years.

farmer. Accordingly, the amici states respectfully request the Court to deny certiorari.

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# AMICUS CURIAE

# BRIEF

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No. 86-958

IN THE

# Supreme Court of the United States

October Term, 1986

NORWEST BANK WORTHINGTON and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

vs.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF OF FIRST BANK SYSTEM, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

This brief addresses the first two questions presented by Petitioners in their Joint Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

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ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF OF FIRST BANK SYSTEM, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

This brief, *amicus curiae,* is filed by First Bank System, Inc. (First Bank System), with the consent of the parties, pursuant to Rule 36.1 of this Court.

## INTEREST OF AMICUS CURIAE

First Bank System was, as of year-end 1985, the fifteenth largest bank holding company in the United States and consisted of 78 banks and trust companies with 148 banking offices in Minnesota, North Dakota, South Dakota, Montana, and Wisconsin, and a trust company in Florida. Its two flagship banks, First Bank Minneapolis and First Bank St. Paul, are the largest banks in those two major cities.

Because First Bank System, through its constituent banks and financial service subsidiaries, has a loan portfolio of many billions of dollars, its interest in the operation and judicial administration of the United States Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, is substantial. First Bank System must rely on the Bankruptcy Code and the judicial decisions interpreting it to determine its rights when its borrowers fail to meet their obligations and file bankruptcy petitions under the Bankruptcy Code. In its business of providing financial services, First Bank System is concerned that the Bankruptcy Code be administered fairly and consistently.

The majority opinion of the Court of Appeals for the Eighth Circuit improperly injected uncertainty and insecurity into the lending process by 1) holding that the absolute priority provisions of 11 U.S.C. § 1129 and this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), may be avoided simply by the debtor's non-cash promise to provide future labor, experience, and expertise; and by 2) permitting a debtor's retention and use of mortgaged real estate and other collateral subject to a creditor's lien without providing any protection, pursuant to 11 U.S.C. §§ 361 and 362(d), against decline in the value of the creditor's interest in the collateral until after expiration of applicable state notice and redemption periods. Such results are of concern not only to First Bank System and its shareholders, but also to all potential borrowers who inevitably will be faced with increased difficulty in obtaining and affording credit. First Bank System therefore supports Petitioners' request for a writ of certiorari.



## SUMMARY OF ARGUMENT

1. The principle of absolute priority prevents a debtor from retaining an ownership interest in a reorganized enterprise if any objecting class of creditors has not been fully compensated for its allowed claims in the bankruptcy case. Only if the debtor provides new capital to the reorganized enterprise may he retain an ownership interest. When the Court of Appeals permitted the possibility that a farm debtor's promise of future contributions of labor, experience, and expertise could constitute a contribution of capital sufficient to permit participation in the reorganized enterprise, it violated the requirement of 11 U.S.C. § 1129(b)(2)(B), pertinent legislative history, and this Court's guideline established in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). Moreover, the Court of Appeals, by its decision, potentially subjected every bankruptcy case filed under Chapter 11 to the extensive delays, expense, and frustration required by attempting to value intangible contributions that can never be the equivalent of capital. This Court need not and should not permit the Court of Appeals' expressed concern for the family farm economy to result in bad law applicable to all reorganization cases, since Congress, shortly after the decision below, enacted legislation addressed to the family farmer's situation.

2. Both the fifth amendment to the United States Constitution and 11 U.S.C. §§ 361 and 362(d) require that a creditor be compensated for the use of its collateral by a debtor

in bankruptcy. At a minimum, the creditor must be adequately protected against loss of value in the collateral itself. The weight of authority also requires that the creditor be adequately protected against lost opportunity, or the benefit of the creditor's bargain, when that creditor is prevented from liquidating its collateral and reinvesting the proceeds. When the Court of Appeals held that a creditor is entitled to no adequate protection payments until such time as it could have liquidated its collateral after all notice and redemption periods had expired under state law, and that the value of the collateral to be protected would be determined only at that time, it violated the applicable constitutional and statutory requirements. Congress's recent enactment of legislation governing the bankruptcy proceedings of family farmers provides further indication that the Court of Appeals erred in depriving the creditors in this Chapter 11 case of adequate protection payments.



## ARGUMENT

### I. PERMITTING DEBTORS TO AVOID THE ESTABLISHED LEGAL PRINCIPLE OF ABSOLUTE PRIORITY IS CONTRARY TO STATUTE, LEGISLATIVE HISTORY, THIS COURT'S PRECEDENT, AND GOOD PUBLIC POLICY, AND IS MOREOVER INAPPROPRIATE IN LIGHT OF RECENT CONGRESSIONAL LEGISLATION.

#### A. The Court Of Appeals Disregarded Clear Statutory Language, Directly Relevant Legislative History, This Court's Precedent In *Case v. Los Angeles Lumber Products Co.*, and Good Public Policy.

The Bankruptcy Code provides that any debtor's plan of reorganization which impairs an objecting class of unsecured claim holders may only be confirmed if the plan does not discriminate unfairly, and is fair and equitable. 11 U.S.C. § 1129(b)(1). To be fair and equitable, the plan must provide either that each such holder of an unsecured claim will receive value equal to the allowed amount of its claim, 11 U.S.C. § 1129(b)(2)(B)(i), or that no holder of any junior interest will receive or retain "any property," 11 U.S.C. § 1129(b)(2)(B)(ii). The Court of Appeals below acknowledged that no realistic plan of reorganization could provide the unsecured creditors with value equal to the amount of their allowed claims (Pet. A. p. 22), yet permitted the debtors to retain a property interest in the farming operation, in violation of 11 U.S.C. § 1129(b)(2)(B)(ii), provided only that the debtors agree to contribute their "experience, knowledge, and labor to the successful implementation of the plan." (Pet. A. p. 3). The holding is clearly contrary to the statutory provisions governing the bankruptcy process.

The Court of Appeals' strained attempt to preserve the debtors' ownership interest is also contrary to the legislative history of 11 U.S.C. § 1129(b). The Commission on Bankruptcy Laws, established by Congress to consider a new bankruptcy code in the early 1970's, recommended that the absolute priority rule be loosened to permit continued participation in the plan by owners or shareholders, even in the face of unpaid unsecured claims, if the owners or shareholders would "make a contribution which is important to the operation of the reorganized debtor. . . ." Report of Commission on Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. 242 (1973). Implementation of such a recommendation would have circumvented the absolute priority rule. When Congress rejected that approach, and adopted the absolute priority rule of § 1129(b)(2)(B), it said simply: "[T]he bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all." H.R. Rep. No. 595, 95th Cong., 2d Sess. 224, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963, 6184. The Court of Appeals' holding to the contrary does not withstand scrutiny.

Moreover, the Court of Appeals' decision to override statutory language and legislative history concerning the principle of absolute priority is contrary to the guideline established by this Court almost fifty years ago in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). Far from heeding the instruction of that decision, however, the Court of Appeals latched onto a particular phrase in the decision to justify a result in this case that is completely at odds with this Court's decision in *Los Angeles Lumber Products Co.*

The Court of Appeals noted language in *Los Angeles Lumber Products Co.* requiring that where a debtor is insolvent, the stockholders' continued participation in the reorganization plan must be based on a "contribution in money or in



money's worth"; the Court of Appeals then made the extreme leap in logic to conclude that a farmer's promise to continue operating and managing his farm is measurable in money or money's worth. (Pet. A. pp. 23-24). In fact, however, this Court held precisely to the contrary in *Los Angeles Lumber Products Co.* In that reorganization case under the 1934 Bankruptcy Act, the district court had approved a plan which permitted old stockholders in the business to retain a portion of their interest after the reorganization in exchange for the contribution of "their familiarity with the operation of the business and their financial standing and influence in the community," and because they could provide "continuity of management." 308 U.S. at 112-13. This Court soundly and unanimously rejected that position, holding:

> The findings below that participation by the old stockholders will be beneficial to the [objecting creditors] because those stockholders have 'financial standing and influence in the community' and can provide a 'continuity of management' constitute no legal justification for issuance of new stock to them. Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests, would serve as easy evasions of the principle of full or absolute priority. . . . They reflect merely vague hopes or possibilities.

308 U.S. at 122-23. *See Metropolitan Holding Co. v. Weadock*, 113 F.2d 207, 209 (6th Cir. 1940) (skill and experience of stockholders in management of reorganized enterprise is not money or money's worth).

The Court in *Los Angeles Lumber Products Co.* did not preclude the possibility that provision of "new money essential to the success of the undertaking" could permit participation

in the reorganization by old shareholders. 308 U.S. at 121. As the Court made clear, however, the promise of future services to the enterprise is not the "new money" required to allow continued participation by the owners while objecting creditors remain unpaid. The principle underlying the Court's decision had perhaps been best enunciated in *Louisville Trust Co. v. Louisville, New Albany & Chicago Railway*, 174 U.S. 674 (1899):

> [T]he stockholder's interest in the property is subordinate to the rights of creditors. . . . And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights . . . of creditors comes within the judicial denunciation.

174 U.S. at 684.

By its decision, the Court of Appeals has, beyond disregarding statutory language, legislative history, and the guideline of this Court, created a procedural and public policy morass with the potential to affect every reorganization case, whether agricultural or commercial. As Judge Gibson argued in his dissent, there is "extreme illogic" in attempting to analogize from capital contributions to contributions of labor, experience, and expertise. (Pet. A. pp. 34-35). Labor is not capital, and is not liquid; its use as a medium of exchange in the creditor's hands is nill. Moreover, because such intangible contributions can be valued, if at all, only with extreme uncertainty and difficulty, their use in reorganization plans will potentially subject every reorganization case, every creditor, and every bankruptcy court to extensive delays, expense, and frustration. Finally, the promise of future contributions of labor, experience, and expertise, even if measurable in the abstract, is wholly unacceptable in the reality of a failing



enterprise where that promise is unenforceable and made without security to the creditors left with unsatisfied claims.

In truth, a debtor's promise to continue contributing labor, experience, and expertise to the reorganized enterprise in the future cannot, even under a wildly abstract theory which considers those intangibles capital, constitute the new, additional injection of funds contemplated in *Los Angeles Lumber Products Co.* It is, after all, those very intangibles which a borrower implicitly pledges when first seeking any agricultural or commercial loan. That the debtor is willing to contribute to the reorganized business the same labor, experience, and expertise that were insufficient to prevent economic failure of that same business in the first instance is hardly the kind of additional contribution which justifies the judicial dispossession of creditor interests firmly established by statute and this Court's precedent. The Court should grant certiorari to correct this misapplication of the law.

### B. Recent Congressional Enactment Of The Bankruptcy Judges, United States Trustees, And Family Farmers Bankruptcy Act of 1986 Has Removed All Justification For Preservation Of Bad Law Created By The Court Of Appeals In Attempting To Alleviate The Farm Crisis.

In its opinion filed on July 2, 1986, the Court of Appeals said that the case before it raised "important questions of bankruptcy law, particularly as that law relates to farmers who have filed petitions for reorganization under Chapter 11 of the Bankruptcy Code." (Pet. A. p. 2). Judge Gibson, in his dissent, appropriately recognized that:

> Understandably sympathetic in the face of admittedly acute difficulty gripping the nation's entire farm economy, the court unabashedly legislate[d] a

> result which undermines reasonable commercial expectations, and substantially reorders the risks of insolvency borne by farm debtors and their bankers. (Pet. A. p. 28).

Even as the Court of Appeals was deciding the case below, Congress was considering the troublesome issues raised by the current state of the nation's farm economy. And in October, 1986, Congress enacted the Bankruptcy Judges, United States Trustees, and Family Farmers Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. ___ (Codified at 11 U.S.C. § 101 *et seq.*). Congress acted because "many family farmers have found Chapter 11 needlessly complicated, unduly time consuming, inordinately expensive and, in too many cases, unworkable." H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48, *reprinted in* 1986 U.S. Code Cong. & Ad. News 5227, 5249.

Newly enacted Chapter 12, to be used only by family farmers with debt of less than $1.5 million and with regular annual incomes, as defined by 11 U.S.C. §§ 101(17)-(18), was designed to "give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land." *Id.* Importantly, however, Congress made clear that while the new Act is to provide family farmers the "important protection from creditors that bankruptcy provides," it should also "[prevent] abuse of the system and [ensure] that farm lenders receive a fair repayment." *Id.*

Newly enacted 11 U.S.C. § 1225(b) substantially modifies the absolute priority rule in reorganization cases filed by family farmers:

> (1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—



> (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
>
> (B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period, or such longer period as the court may approve under Section 1222(c), beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.
>
> (2) For purposes of this subsection, 'disposable income' means income which is received by the debtor and which is not reasonably necessary to be expended—
>
> (A) for the maintenance or support of the debtor or a dependent of the debtor; or
>
> (B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

Congress declined to apply retroactively the newly enacted Chapter 12 to cases begun under the Bankruptcy Code before the effective date of the Act. § 302(c)(i), Pub. L. No. 99-554.

Section 1225(b)(1) permits a family farmer, as a debtor under Chapter 12, to retain income which is reasonably necessary for the maintenance or support of the debtor or a dependent of the debtor or for payments and operation of the debtor's farm business. By permitting the family farmer to retain such an interest in the business, even when creditors are not fully paid, Congress has substantially altered the principle of absolute priority in these limited circumstances.

Congress, in its legislative capacity, passed the family farm legislation, and this Court need not now address its wisdom or interpret its substantive provisions. The Act is significant, however, because it is the product of a deliberative legislative

process rather than makeshift judicial policy making. Because Congress has now acted in the area which was presumably of concern to the Court of Appeals, there is even less reason for this Court to let stand the ill-considered decision below, potentially affecting as it does not only agricultural cases but all bankruptcy cases filed under Chapter 11.

Because creditors would be susceptible to greater erosion of their claims and subsequently greater charge-offs for bad debt, the Court of Appeals' decision will result in more restrictive and costly credit for all borrowers, not just agricultural borrowers. The decision, based on faulty interpretation of 11 U.S.C. § 1129(b)(2)(B), its legislative history, and the precedent of *Case v. Los Angeles Lumber Products Co.*, cannot withstand this Court's admonition in *Badaracco v. Commissioner*, 464 U.S. 386 (1984):

> The relevant question is not whether, as an abstract matter, the rule advocated . . . accords with good policy. The question we must consider is whether the policy . . . is that which Congress effectuated by its enactment of [the statute under consideration]. Courts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement.

464 U.S. at 398. The Court of Appeals, attempting just such judicial legislation, was wrong. This Court should grant certiorari to correct the mistake.



## II. THE COURT OF APPEALS' HOLDING THAT A DEBTOR IN BANKRUPTCY MAY AVOID LIFTING OF THE AUTOMATIC STAY WITHOUT PROVIDING ANY PAYMENT FOR ADEQUATE PROTECTION TO UNDERSECURED CREDITORS UNTIL THEY OTHERWISE COULD HAVE OBTAINED THEIR COLLATERAL AND SOLD IT FREE OF ANY RIGHTS OF REDEMPTION DEFIES THE BANKRUPTCY CODE'S REQUIREMENTS AND THE VIEWS OF OTHER CIRCUITS, AND IS INCONSISTENT WITH CONGRESS'S RECENT BANKRUPTY CODE LEGISLATION.

### A. The Court Of Appeals' Decision To Divest Undersecured Creditors Of Their Interest In Collateral By Failing To Require Adequate Protection Payments Under 11 U.S.C. §§ 361 And 362 Is Contrary To Those Statutes, Their Legislative History, And The Weight Of Authority Interpreting Them.

After the undersecured creditors in this case successfully moved under 11 U.S.C. § 362(d) for relief from the automatic stay in order to begin foreclosure proceedings on real estate for which they held mortgages, the Court of Appeals reversed the grant of relief, holding that creditors were entitled to no payments for adequate protection of their interest in collateral until such time as they could have, under Minnesota state law, obtained their collateral free of any right of redemption by the debtors. (Pet. A. pp. 9-12).

The Court of Appeals' decision is contrary to 11 U.S.C. § 362(d) which requires:

> On request of a party in interest and after notice and a hearing, the court *shall* grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

> (1) for cause, including the lack of adequate protection *of an interest in property* of such party in interest. . . . (emphasis added).

When such adequate protection is required, it may be provided in a number of ways, including:

> (1) requiring the trustee to make a cash payment or periodic cash payments . . . to the extent that the stay under Section 362 . . . results in a decrease in the value of such entity's interest in such a property; . . . or
>
> (3) granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

11 U.S.C. § 361.

Two levels of adequate protection have traditionally been addressed by courts which have considered these provisions: 1) protection of the creditor's lost opportunity or "benefit of the bargain" while the debtor retains collateral which the creditor could otherwise liquidate and reinvest, and 2) protection against diminution in the actual value of the collateral while retained by the debtor.

So that the creditor's benefit of the bargain is protected, some courts have construed the "indubitable equivalent" language of 11 U.S.C. § 361(3) to require that the creditor receive compensation for the "lost opportunity" incurred by being prevented from liquidating its collateral and reinvesting the proceeds. *See, e.g., In re American Mariner Industries, Inc.*, 734 F.2d 426 (9th Cir. 1984); *Grundy National Bank v. Tandem Mining Corp.*, 754 F.2d 1436 (4th Cir. 1985). Other courts, including the Court of Appeals prior to the decision below, have held that the bankruptcy court need not award such lost opportunity payments as a matter of law, but may award them based upon the facts of a particular case. *In re*



*Briggs Transportation Co.*, 780 F.2d 1339 (8th Cir. 1985). An occasional Court of Appeals has held that such lost opportunity payments are unavailable as a matter of law, although the principal case endorsing that position is now the subject of redetermination *en banc. In re Timbers of Inwood Forest*, 793 F.2d 1380 (5th Cir.), *rehearing en banc granted*, 802 F.2d 777 (5th Cir. 1986).

By refusing to permit lost opportunity payments, the Court of Appeals below aligned itself with the minority position that declines to reach the logical conclusion that adequate protection of a creditor's interest includes reimbursement of the time value of that interest. For that reason alone, this Court should grant certiorari to clarify the law in this area.

The Court of Appeals, however, went even further, and denied the undersecured creditors any adequate protection payments whatsoever, even those designed to preserve the value of the collateral itself; it did so simply because foreclosure on that real estate collateral would be subject to a notice and redemption period under Minnesota state law. (Pet. A. pp. 9-12). The Court of Appeals ignored the portions of both the bankruptcy court opinion (Pet. A. p. 65) and district court opinion (Pet. A. p. 85) which indicated that at least a portion of the adequate protection payments required to prevent lifting of the automatic stay were to compensate one of the undersecured creditors for the actual loss of value of its collateral due to accruing property taxes and interest on a senior obligation.

The Court of Appeals' failure to provide adequate protection for even the underlying value of the collateral ignores the legislative history of both 11 U.S.C. §§ 361 and 362 which clearly indicates that undersecured creditors are to be given adequate protection against impairment of their interest in collateral by such items as depreciation and use. *See* S. Rep.

No. 989, 95th Cong., 2d Sess. 54, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 5840.

The Court of Appeals added to the creditors' injury when it held that not only were adequate protection payments to be delayed until the close of what would have been the notice and redemption periods under state law, but also that the value of the collateral to be protected would not be calculated until that time, after the risk of loss had already accrued. (Pet. A. pp. 13-14).

There can be no serious doubt that a secured creditor retains an interest in the collateral of its debtor, even during any notice and redemption periods provided by state law. Although the value of that interest may be reduced by the possibility of redemption, there exists value nonetheless. For example, the mortgagee's interest in foreclosed real property is an alienable interest subject only to the rights of redemption of the mortgagor and any junior creditors. Failure to adequately protect the creditor's value of its interest in the collateral during the notice and redemption periods effectively doubles those periods and consequently delays the creditor's ability to liquidate its collateral, even where the reorganization plan is unconfirmed or unsuccessful and adequate protection payments are never made. To deprive the creditor of payments to adequately protect the value of the collateral during that extended period directly violates the adequate protection principles enunciated in 11 U.S.C. §§ 361 and 362.

Failure to adequately protect a creditor's interest in collateral while permitting the uncompensated use of that collateral also runs afoul of the Constitution's fifth amendment prohibition against taking private property without compensation. *See, e.g., United States v. Security Industrial Bank*, 459 U.S. 70, 75 (1982); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589-90 (1935). The Court of Appeals simply erred when it refused to provide adequate protection



for the value of the creditors' interest in their collateral during the putative notice and redemption periods under Minnesota state law. This Court should grant certiorari and reverse.

**B. Congress, By Its Elimination Of Adequate Protection Payments For Lost Opportunity In Newly Enacted Chapter 12 Of The Bankruptcy Code, Indicated That Payments To Adequately Protect The Value Of Collateral Must Always Be Made, And That Adequate Protection Payments For Lost Opportunity May Also Be Required In Chapter 11 Reorganizations.**

As with the absolute priority principles discussed in Part I, above, Congress reacted to the adequate protection requirements of Chapter 11 when it enacted the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 shortly after the Court of Appeals issued its decision below. Newly enacted 11 U.S.C. § 1205(a) eliminates 11 U.S.C. § 361's applicability to Chapter 12. The section goes on to provide:

> (b) In a case under this chapter, when adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
>
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under Section 362 . . . results in a decrease in the value of property securing a claim or of an entity's ownership interest in property; . . .
>
> (3) paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property; or

> (4) granting such other relief . . . as will adequately protect the value of property securing a claim or of such entity's ownership interest in property.

The House Conference Report accompanying the Act noted the holdings of *In re American Mariner Industries, Inc.*, and *Grundy National Bank v. Tandem Mining Corp.*, that the "payment of lost opportunity costs requires the periodic payment of a sum of cash equal to the interest that the undercollateralized secured creditor might earn on an amount of money equal to the value of the collateral securing the debt." H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 49, *reprinted in* 1986 U.S. Code Cong. & Ad. News 5227, 5250. The conferees, however, disapproved of lost opportunity payments for family farmers who "are usually unable to pay lost opportunity costs. Thus, family farm reorganizations are often throttled in their infancy upon motion to lift the automatic stay." *Id.*

The conferees, therefore, endorsed the elimination of any requirement that family farmers pay lost opportunity costs; 11 U.S.C. § 1205 in fact removed the "indubitable equivalent" language of 11 U.S.C. § 361(3). *Id.* Congress wanted to make clear that "what needs to be protected is the value of property, not the value of the creditor's 'interest' in property." *Id.* at 5251.

Congress's action is significant for two reasons. First, it concisely demonstrates that under any adequate protection theory, the court must protect at least the value of property serving as collateral for the undersecured creditor. Second, it recognizes, and does not alter, the principle that adequate protection payments for lost opportunity—the creditor's benefit of the bargain—are a legitimate and continuing component of Chapter 11's provisions applicable to all reorganizations throughout the economy except those involving family farmers



seeking protection under Chapter 12. Congress's action is further evidence that the Court of Appeals committed error in failing to protect the interests of the undersecured creditors below. This Court should grant certiorari and reverse.

## CONCLUSION

The Court of Appeals' decision, if permitted to stand, will improperly and imprudently change the long-standing concepts of absolute priority and adequate protection which are among the cornerstones of the carefully developed balancing of rights and remedies between creditors and debtors under Chapter 11 of the Bankruptcy Code. The changes are wholly unsupported by statutory interpretation, legislative history, governing court precedent, subsequent legislative enactments, or wise public policy. Left unrectified, they will result in the restriction of available credit throughout all sectors of the economy and the increased cost of whatever credit can be found. Policies with such dramatic consequences must be the product of legislative deliberation, not judicial fiat. First Bank System respectfully supports the Petitioners' petition that certiorari be granted to consider and reverse the decision below.

Dated: January 7, 1987.

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# AMICUS CURIAE

# BRIEF

No. 86-958

Supreme Court, U.S.
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CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1986

---

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,

v.

JAMES R. AHLERS and MARY M. AHLERS,

---

# BRIEF AMICUS CURIAE ON BEHALF OF THE MINNESOTA BANKERS ASSOCIATION IN SUPPORT OF JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

---

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## BRIEF AMICUS CURIAE OF THE MINNESOTA BANKERS ASSOCIATION

### INTRODUCTION

The purpose of this brief amicus curiae is to assist the United States Supreme Court in resolution of the Joint Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit by indicating to the Court the adverse public policy consequences of the Appellate Court's decision.

This brief is being filed conditionally with the consent of the parties pursuant to the Supreme Court Rules, Rule 36.1.

### INTEREST OF AMICUS CURIAE

The interests of the amicus curiae are demonstrated as follows:

1. The MBA is a commercial bank trade association operating as a not-for-profit corporation organized under the laws of Minnesota. Its membership consists of approximately 717 state and national banks located and doing business throughout the state of Minnesota. All but 16 commercial banks in Minnesota are members of the MBA.

2. As set forth in its Articles of Incorporation, the MBA is charged with the responsibility of promoting "...the general welfare and best interests of banks and bankers in Minnesota...." To this end, the MBA has frequently represented the views of Minnesota banks before legislative and judicial bodies.

3. Minnesota banks have historically viewed the United States Bankruptcy Code and the body of judicial decisions that have been decided under it as a consistent guide for determining their rights in the event that one of their borrowers files a bankruptcy petition under Chapter 11 of the Bankruptcy Code. Part of this framework for lending has been the consistent manner in which adequate protection has been granted to secured creditors where the bankruptcy court determines not to lift an automatic stay and to allow the debtor to remain in possession of collateral. Another part of this framework has been the refusal of bankruptcy courts under well established legal



principles to permit a debtor to obtain an equitable ownership interest in the debtor's property and participate in the reorganization plan ahead of unsecured creditors, who have a senior interest in the estate, absent a capital contribution in an amount at least as great as that retained interest.

4. The decision of the Eighth Circuit Court of Appeals concerning which a writ of certiorari is sought is of concern to the MBA because of the uncertainty that it will cause its members who extend credit, whether it be secured or unsecured and whether it be farm or business credit. The perpetuation of this uncertainty will hamper the extension of credit to all business and agricultural borrowers, but, most significantly, it will further diminish the availability of credit to the struggling agricultural sector of the economy and further increase its cost.

## SUMMARY OF ARGUMENT

As a matter of sound public policy, fairness and consistency have been and must

continue to be the underpinnings of the bankruptcy law. The decision of the Court of Appeals in this case, if allowed to stand, departs so significantly from past bankruptcy precedent as to change creditor expectations in much the same manner as a legislative enactment. The court goes to such great lengths to help the farmer-debtor that it deprives the lenders in the instant case of all fairness and equity, and it creates an expectation for lenders that, in future bankruptcy cases, their bargained-for rights will be ignored with impunity by the courts.

The farm economy is in straits as dire as we have ever seen them, but insolvent farmers are not the only ones who are victimized. All commercial enterprises, including banks, that serve the agricultural sector of the economy, suffer as well. Indeed, bank failures, led by those in predominently agricultural states, occurred in greater number in 1986 than at any time since the great depression of the 1930s.



Although most rural banks will not fail, they will have to make adjustments in order to survive. If creditor and debtor rights are not balanced equitably, credit will have to be further restricted and viable farm borrowers will be forced to share the cost of the losses through interest rates on agricultural loans that are higher than they would otherwise have to be.

However, the decision in this case is not confined to farm bankruptcies. As a result, its implications for commercial credit of all types are also significant. Although the impact cannot be precisely quantified, both commercial and farm credit will undoubtedly tighten and become costlier.

## I. COURT OF APPEALS DECISION MAKES SIGNIFICANT PUBLIC POLICY CHANGES THAT SHOULD BE MADE, IF AT ALL, THROUGH LEGISLATIVE ENACTMENT, NOT JUDICIAL FIAT

As is being argued in the petitioner's brief, the Court of Appeals, in its denial of adequate protection for the farm real estate secured lender for one year and six weeks and

its willingness to turn the absolute priority rule inside out and totally cut off the rights of unsecured claimants, diverges significantly, indeed virtually rejects, statutory law as enacted by Congress and interpreted by the U.S. Supreme Court in Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939); and the Eighth Circuit Court of Appeals in In re Briggs Transportation Co., 780 F.2d 1339 (8th Cir. 1985); and In re Martin, 761 F.2d 472 (8th Cir. 1985).

These are not minor variances in established law necessary to correct inequities present in a particular case. The court's decision rewrites clearly established statutory law in a manner that totally ignores the role of the legislative branch of government in establishing public policy. Even where the court cites established judicial precedent, it ignores or tortures the reasoning of those judicial precedents to justify its own public policy prerogatives.

We realize it is the court's compassion that has determined its judgment, but it is



not the court's compassion that should serve as the sole justification for establishing new law without the public policy input and deliberative methods which legislative policymaking bodies are able to utilize.

Indeed, the United States Congress has just recently enacted new legislation based upon such deliberative policymaking on the farm bankruptcy issue. Pub. Law 99-554, 100 Stat. ____ (H.R.5316). This legislation is the Congressional response to the deteriorating farm situation. Effective November 26, 1986, it gives the farmer-debtor new tools to reorganize without infringing on the rights of creditors in the manner of the court of appeals in the instant case. It facilitates farmer bankruptcy reorganizations by enacting a new chapter 12 to the Bankruptcy Code, Title 11, United States Code, sections 1201 et seq., which increases the amount of time for filing the reorganization plan, expands farmer eligibility to those with up to $1.5 million in debt, lengthens the permissible term of the plan and widens

adequate protection options for the farmer-debtor.

The Minnesota Legislature, in its public policymaking capacity, also enacted numerous legislative initiatives in the 1986 legislative session to benefit the farmer. The changes include limitations on the right of secured creditors to deficiency judgments (Laws 1986, Chapter 398, Article 19), creation of the right to mandatory mediation by state appointed mediators (Id., Article 1), creation of new rights of first refusal for farm borrowers (Id., Article 20), an increase in the size of the farm homestead exemption (Id., Article 16), clarification of the right to crop proceeds after the period of redemption (Id., Article 12), and more.

While the MBA does not agree with all the public policy decisions that were made by Congress and the Minnesota Legislature, at least they were made in a forum that grants the opportunity for public input and consideration of various policy options as to the competing rights of the affected parties.



II. ADEQUATE PROTECTION DELAY UNFAIRLY DOUBLES TIME OF UNCOMPENSATED USE OF REAL PROPERTY COLLATERAL, AND THE SAME LOGIC COULD BE USED BY FUTURE COURTS TO UNCOMPENSATED USE OF PERSONAL PROPERTY AS WELL

In ruling that a Minnesota farm real estate lender is not entitled to adequate protection for a period equal to the statutory redemption period plus the period of notice of public sale (one year and six weeks), the court ignores prior precedent in establishing adequate protection payments and ignores factual and equitable considerations that were considered by the bankruptcy court and the district court.

The Eighth Circuit Court of Appeals, in In re Briggs Transportation Co., 780 F.2d 1339 (8th Cir. 1985), held that in determining what interests of the creditor should be afforded protection during the pendency of an automatic stay, final reconstruction of the creditor's bargain is a balancing act best left to the discretion of the bankruptcy judge. In the instant case, however, the court substitutes its own opinion that, as a matter of law, a bankruptcy court cannot provide for adequate protection payments during the public sale

notice and redemption periods established by state law. See Minn. Stat., Secs. 580.03; 580.23, subd. 2; and 580.24 (1986). (The court failed to mention the 60-day notice of default period and the additional two-weeks' public sale notice period applicable to all homestead property under Minn. Stat., Secs. 47.20, subd. 15, and 580.031 (1986)).

The court, in effect, is doubling the period during which a creditor must allow the debtor to use its property without receiving any compensation for that use simply because the creditor failed to start foreclosure proceedings prior to filing of the bankruptcy petition. Those periods were set by statute and have been changed from time to time to reflect the state legislature's consideration of what legal protections are fair for an owner of real estate in light of other protections which are also available under the law. The periods are intended to define only the window during which a borrower may reinstate a mortgage or redeem mortgaged realty. The court, by retroactively doubling



that grace period, deprives the lender of valuable bargained-for contractual rights for that additional period.

This issue is of great concern to the MBA, since its members increasingly rely on security of farm real estate in extending farm credit. However, the decision in this case has much more far-reaching implications in light of new protections which have recently been enacted by the Minnesota Legislature. See Laws 1986, Chapter 398, as amended. The new law provides for a delay in enforcement of remedies, including security interests in both personal property and real property used for agricultural production.

Article 1 of this law establishes a debtor's right to mandatory mediation through July 1, 1988. It requires that a notice of the right to mediate be sent by a creditor prior to commencing any action for collection of the debt of more than $5,000 secured by agricultural property. The debtor then has 14 days in which to request mediation. If mediation is requested, the University of

Minnesota Agricultural Extension Service, the agency in charge of administering mediation, has ten days in which to notice an initial meeting, which must take place within 20 days of the notice. Mediation may continue to 60 days following that. If there is a mediator determination that a creditor has failed to mediate in good faith, all creditors of that debtor may be forced into court-supervised mediation for an additional 60-day period. If one of the creditors is deemed by the court to have failed to mediate in good faith during this period, an additional 180-day stay can be applied to all creditors. These delays apply even where a creditor has obtained a release of the collateral from a bankruptcy stay. Thus, there is a potential for a 300-plus day delay built into state law currently, in addition to delays related to bankruptcy.

In order to be consistent with the holding of the court in the instant case, future courts may well hold that secured creditors in Minnesota are not entitled to adequate protection during part or all of the



time periods set forth in the mediation act. Therefore, in the case of personal property as well as real estate, there would be significant delays in the right to receive adequate protection payments as a matter of law.

## III. EXPANSION OF ABSOLUTE PRIORITY RULE COROLLARY FOR CAPITAL CONTRIBUTIONS IS WITHOUT PRECEDENT, FAIRNESS, AND LOGIC, AND IMPEDES BOTH FARM AND COMMERCIAL CREDIT

In deciding that experience, knowledge, and labor are the equivalent of capital and thus can be used to force a reorganization plan that would allow the debtor to participate in the plan ahead of impaired unsecured creditors, the court of appeals "works an expansion of the rule of absolute priority that is unprecedented, illogical, and unfair." In re Ahlers, 794 F.2d 388, 406 (8th Cir. 1986) (dissenting opinion).

The dissenting opinion clearly points out why contributions of labor and management experience cannot be considered as cash equivalents justifying an exception to the rule of absolute priority. First, labor is

not a means of exchange in our economy as is capital; for it is illiquid and cannot be turned to another use. In short, it has little protective value. Second, value of a farmer's experience, knowledge, and labor to a failing farm is speculative. Third, the contribution being offered for substitution is merely a promise of future labor, which can hardly be supervised or enforced at all, much less be in hand at the time of confirmation of the plan.

What the court is really saying is that, whenever debtors must reorganize in bankruptcy, they may offer to their creditors as new value something which they have already promised when originally applying for credit. Their labor and management expertise, even if it could be accurately valued and considered a cash substitute, is nothing new. It is what the creditor has already bargained for and has the right to receive. It is something which all lenders rely upon and expect will be contributed at the time the credit is extended. To hold otherwise is to decide that



the farmer-debtor never intended to provide the labor or that the lender never expected him to, and that would ignore reality.

Not only does the court's conclusion on this issue alter credit expectations in the troubled farm sector, but in the business sector as well, for the impact of the holding is not limited to only farm debtors. Clearly, if the court's decision is allowed to stand, commercial borrowers will be quick to claim their rights to substitute their time and expertise for capital as well. Indeed, all of commercial and agricultural lending will be affected and re-evaluated with the knowledge that any unsecured claim in bankruptcy can simply be cut off as the debtor carries on the business his spurned former creditors helped finance.

## CONCLUSION

If the joint petition for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit is denied and the decision of that court is allowed to stand, it will have significant adverse

consequences on the cost and availability of both agricultural and commercial credit in Minnesota and other states in the Eighth Circuit. The decision will allow bankrupt debtors with no hope of survival to avoid their creditors at the expense of other farm and commercial borrowers and at the expense of creditors who relied on the clear requirements of the Bankruptcy Code and court precedent in extending credit.

Recent state and federal legislative developments demonstrate that the appropriate legislative bodies charged with making public policy in the area of debtor and creditor relations are fulfilling their responsibilities by studying these issues and problems with input from all those affected and by enacting laws which take into account the full panoply of legal rights and remedies afforded to debtors and their creditors. The court's decision ignores the proper roles of the legislative and judicial branches of government at a time when careful and



deliberate consideration of the solutions to the agricultural crisis is most needed.

For the foregoing reasons, the MBA respectfully requests that the Joint Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit be granted.

Dated: January 6, 1987

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# AMICUS CURIAE

# BRIEF

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No. 86-958

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

---

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners*,

v.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents*.

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

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## BRIEF AMICUS CURIAE FOR AMERICAN COUNCIL OF LIFE INSURANCE IN SUPPORT OF THE PETITION

---

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## QUESTIONS PRESENTED

The questions addressed by the *amicus curiae* are:

1. Does the promise by a debtor to contribute labor and expertise in the future, constitute a present contribution of capital enabling the confirmation of a plan of reorganization that does not meet the requirements of 11 U.S.C. § 1129(b)(2)(B)?

2. Does the Bankruptcy Code permit an interpretation that adequate protection against diminution of the value of, and the debtor's interest in the collateral (i) may be postponed for a period equal to the time the court determines it would take to foreclose, and to obtain possession of the collateral free of redemption rights without granting relief from the automatic stay as required by 11 U.S.C. § 362(d)(1); and (ii) may not be awarded on a monthly basis where the debtor receives income, if at all, at the end of the growing season?

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## BRIEF AMICUS CURIAE FOR AMERICAN COUNCIL OF LIFE INSURANCE IN SUPPORT OF THE PETITION

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This brief is filed on behalf of the American Council of Life Insurance as *amicus curiae*, in support of the Joint Petition for Certiorari.[1]

### INTEREST OF AMICUS CURIAE

The American Council of Life Insurance ("Council") is a nonprofit voluntary trade association incorporated under the laws of the State of Delaware, the membership of which totals 636 legal reserve life insurance companies doing business throughout the United States. The member companies of the Council account for 93.9 percent of the legal reserve life insurance in force in the United States and afford protection to 154 million insureds.

Life insurance companies are among the nation's largest direct lenders of mortgage money and purchasers of mortgages on the secondary mortgage market. At the end of 1985, life insurance companies held $171.8 billion in mortgages on U.S. real property, which represented 20.8 percent of the total assets held by life insurance companies in that year.[2]

Due to the long involvement and experience of life insurance companies with real estate mortgages, the Council is uniquely qualified to comment on the language and purpose of the Bankruptcy Code governing cramdown against, and adequate protection of the real estate mortgagee, and the legitimate expectations of mortgage lend-

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[1] Consents from counsel for the parties have been filed with the Clerk of this Court.

[2] American Council of Life Insurance, *1986 Life Insurance Fact Book* at 83 (ACLI, Washington, D.C. 1987).

ers that the Eighth Circuit decision would frustrate. The Council offers this *amicus curiae* brief in support of the Joint Petition for Certiorari, and to explain the adverse and potentially profound economic loss that lenders, the real estate industry and the national economy could suffer if the questions raised in this case are not quickly resolved.

## SUMMARY OF ARGUMENT

The Eighth Circuit's determination that a promise by a debtor to contribute labor and expertise in the future constitutes a present capital contribution enabling the debtor to retain an interest in property while unsecured creditors remain unpaid, is contrary to the express language of Section 1129(b)(2)(B) of the Bankruptcy Code and the absolute priority rule incorporated therein. It is clearly contrary to the intention of Congress, which considered and rejected a proposal by the "Commission on the Bankruptcy Laws of the United States" when the Bankruptcy Code was being drafted, to permit participation by junior interests based upon promises of future assistance. The determination is also contrary to the language of the case cited by the Eighth Circuit (*Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939)), which rejected the idea that such intangibles could constitute present contributions of capital.

The Eighth Circuit's determination that entitlement to adequate protection should be postponed for a period equivalent to the time it would take a mortgagee to foreclose free and clear of redemption rights is inconsistent with the Bankruptcy Code, violates the intention of Congress, and has the effect of denying effective adequate protection to mortgagees, especially in those jurisdictions where there is a long foreclosure or redemption period. Furthermore, the court's determination that payments when authorized should be paid only at the time the debtor expects to earn income, has the effect of shifting the entrepreneurial risk of the debtor's business to the secured creditor and is not consistent with the language of the statute or Congressional intent.



The Eighth Circuit's decision goes to the heart of Chapter 11—cramdown and adequate protection—and while *Ahlers* dealt with a farming operation, the holding affects all Chapter 11 cases. The holding in *Ahlers*, now the law of the Eighth Circuit, will be raised in numerous cases throughout the country resulting in increased litigation costs and crowding of court calendars. It will have a severe adverse effect upon the insurance industry, which has billions of dollars invested in mortgage loans, as well as other lenders, all of whom are concerned that the bankruptcy laws be administered uniformly throughout the country.

## ARGUMENT

### REASONS PETITION SHOULD BE GRANTED

### I. THE EIGHTH CIRCUIT HAS MISINTERPRETED SECTION 1129(b)(2)(B) OF THE BANKRUPTCY CODE, 11 U.S.C. § 1129(b)(2)(B).

#### A. The promise by a debtor to contribute labor and expertise in the future does not constitute a present contribution of "money or money's worth" under this Court's decision in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

The Eighth Circuit held in *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986), that the promise by the debtor to contribute labor, experience and expertise in the future represented a present contribution of money or money's worth entitling the debtor to participate in the reorganization even though dissenting senior creditors would receive less than their allowed claims, on the ground that this Court "specifically recognized that there may be circumstances in which the absolute priority rule could be modified. . . ." 794 F.2d at 401.

Yet the very case cited by the Eighth Circuit rejected that view. In *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), this Court recognized as a corollary to the absolute priority rule, that when new money is necessary, there is no objection if "old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution." 308 U.S. at 121.

In *Los Angeles Lumber* this Court dealt with the question of what constituted a new contribution of "money or money's worth" (308 U.S. at 122-23) that would entitle the participant to such an interest and specifically rejected the concept that intangible benefits, having no place in the asset column of the balance sheet, could be considered a contribution of money's worth. In that case the District Court had allowed the old stockholders to participate in the reorganized company. *In re Los Angeles Lumber Products Co.*, 24 F. Supp. 501 (S.D. Cal. 1938). The opinion stated that the old stockholders "are the only persons familiar with the company's operations and who have had experience in shipbuilding" (24 F. Supp. at 513) and that this, together with the benefit of the stockholders' "business contacts" (24 F. Supp. at 513), and "continuity of experienced management" (24 F. Supp. at 514), constituted a contribution sufficient to allow the stockholders to participate in the reorganized company notwithstanding the fact that senior interests remained uncompensated.

This Court, in overruling the District Court and the Ninth Circuit Court of Appeals, *In re Los Angeles Lumber Products Co.*, 100 F.2d 963 (9th Cir. 1939), said that such items were illustrative of "a host of intangibles which, if recognized as adequate consideration . . . would serve as easy evasions of the principle of full or absolute priority. . . . They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities." 308 U.S. at 122-23 (footnotes omitted). Obviously a debtor's unenforceable promise to work hard in the future, contributing "experience, knowledge and labor", would have no place in the asset column of a balance sheet and thus the decision below reflects the same "vague hopes or possibilities" the very decision of this Court cited by the Eighth Circuit rejected. Indeed, it is often the inexperience, lack of expertise and carelessness of the debtor that causes the debtor's financial plight. Even in the worst of economic circumstances, those individuals and enterprises that fail are often the less efficient and least capable, especially in connection with their individual service and performance contributions to the business. It is inconceivable that a debtor's promise to continue what may have been inadequate performance should be the basis for denying senior interests their right to absolute priority.



**B. The Eighth Circuit opinion that a promise of future work constitutes a capital contribution permitting the court to avoid the absolute priority requirement, is contrary to the express language of section 1129(b)(2)(B) of the Bankruptcy Code, 11 U.S.C. § 1129(b)(2)(B).**

Section 1129(b)(2)(B) of the Bankruptcy Code requires that, with respect to a dissenting impaired class of unsecured claims, the plan must provide that each holder of a claim receive property of a value "equal to the allowed amount of such claim," or no junior claim or interest may "receive or retain under the plan on account of such junior claim or interest *any property*." (Emphasis added.) This provision reads as follows:

> (B) With respect to a class of unsecured claims—
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

The Eighth Circuit admits that under the Ahlers' proposal, the plan could not provide property for the unsecured creditors equal to the allowed amount of their claims. "[W]e agree, that any realistic reorganization plan proposed by the Ahlers could not provide the unsecured creditors with property equal to the amount of their allowed claims. Thus, any feasible plan would not meet the 'fair and equitable' standard of section 1129(b)(2)(B)(i)." 794 F.2d at 401.

Nevertheless, the court permits retention of an ownership interest by the Ahlers and concludes that it is not "fatal to the Ahlers' plan being 'fair and equitable' under section 1129(b)(2)(B)(ii)." 794 F.2d at 401. This revision of the statutory language is supported by the court through its misinterpretation of the pre-Bankruptcy Code *Los Angeles Lumber* case (discussed above) to permit the absolute priority requirement of 11 U.S.C. § 1129 to be modified by considering the promise of future labor as present capital.

In further support of its conclusion that the plan is fair and equitable, the court maintains that the debtor's retained equity had little value because the debtor would not realize any "real profit" from the retained equity until the reorganization plan was completed and the allowed amount of the secured claims paid. Therefore, the court concludes, unsecured creditors "cannot complain." 794 F.2d at 403. However, the value of what the debtor retains is not germane to 11 U.S.C. § 1129(b)(2)(B). That section provides that unless the unsecured creditors are fully compensated, junior interests may receive *no property*. It makes no provision for a differing rule based on the value of what is being retained. *See In re*



*Genesee Cement, Inc.*, 31 Bankr. 442 (Bankr. E.D. Mich. 1983); *In re Huckabee Auto Co.*, 33 Bankr. 132 (Bankr. M.D. Ga. 1981); and *In re Landau Boat Co.*, 13 Bankr. 788 (W.D. Mo. 1981). *Contra In re Star City Rebuilders, Inc.*, 62 Bankr. 983 (Bankr. W.D. Va. 1986).

In addition, the Eighth Circuit argues that the plan was fair and equitable because unsecured creditors would get nothing if the plan were rejected. 794 F.2d at 402. Whether a plan should be rejected by unsecured creditors, however, should be determined by the unsecured creditors when they vote to accept or reject the plan, and not by the court. This Court has held that "[t]he fact that bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan under Section 77B can have no relevant bearing on whether a proposed plan is 'fair and equitable' under that section." *Los Angeles Lumber*, *supra*, 308 U.S. at 123.

Finally, the Eighth Circuit takes comfort in "the broad rehabilitative purposes of the Bankruptcy Act" (794 F.2d at 402), apparently believing that these purposes permit the court to modify the statutory language. While the Bankruptcy Code has rehabilitative purposes, "the relevant goal . . . is not that a firm stay in business, but rather that its assets are deployed in a way that, consistent with applicable nonbankruptcy restriction, advances the interests of those who have rights in them." Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 118 (1984). As stated by Judge Gibson in his *Ahlers* dissent, serious policy questions "can best be considered by the Congress. We, however, are advised to confine our efforts to deciding cases on the law as written and on the facts as found." 794 F.2d at 408.

**C. The Eighth Circuit's circumvention of the absolute priority requirement is contrary to the intent of, and was rejected by Congress.**

In drafting the Bankruptcy Code, Congress specifically considered a proposal for changing the absolute priority rule in a manner similar to the Eighth Circuit's holding in *Ahlers*, and rejected it. The initial proposed bankruptcy bill contained a provision that would have, like *Ahlers*, permitted expertise, promised management and the like to justify participation in the plan by equity owners while creditors remained unpaid. Congress, however, refused to accept the proposal and instead adopted the absolute priority rule.

On July 24, 1970, then President Nixon appointed a Commission on the Bankruptcy Laws of the United States ("Commission") to consider a revision of the Bankruptcy Act. The Commission completed its work in July of 1973 after an extensive study and submitted its Report ("Commission Report") containing a proposed new bankruptcy law ("Commission Bill"), which was submitted to Congress in 1973. H.R. Doc. No. 137, Parts I and II, 93d Cong., 1st Sess. (1973). The Commission Report represented a major step toward the eventual adoption of the Bankruptcy Code.

The Commission Report discussed the nature, development, justification and deficiencies of the absolute priority rule, noting that it had become a "strait jacket" since under it, unless all unsecured claims were paid in full, equity security holders could not participate even by agreement of all the classes of creditors. Commission Report, Part I, at 256-57. This deficiency has been overcome in the Bankruptcy Code as enacted by limiting absolute priority to *dissenting* impaired classes. The Commission, however, had suggested another solution. It recommended that "the fairness test be modified . . . by allowing equity security interests to participate if their future contributions, e.g., continued management, are



essential to the business." Commission Report, Part I, at 258.

The Commission Bill, in § 7-303(4) provided that a plan of reorganization:

> may provide, if the court finds that, (A) in the case of a partnership debtor, when the partners retain an interest under the plan, (B) in the case of an individual, when he retains an interest under the plan, and (C) in the case of a corporate debtor, when the equity security holders retain an interest under the plan, the individual debtor, certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution.

This proposed modification of the absolute priority rule created a storm of controversy. *See* Brudney, *The Bankruptcy Commission's Proposed "Modification" of the Absolute Priority Rule*, 48 Am. Bankr. L.J. 305, 337 (1974),[3] where the author stated:

> The Commission apparently thinks that the 'business contacts . . . with financial institutions . . . and . . . customers' which the District Court found in the *Los Angeles Lumber Products Co.* case were to be contributed by 'stockholders of financial influence and stability' are important enough to justify the issuance of new stock to them. But the Commission's mere *ipse dixit* offers no answer to the Supreme Court's response that those kinds of 'vague hopes or possibilities' were too 'ephemeral' to be valued and would simply 'serve as easy evasions of

[3] *See also* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule of Corporate Reorganizations*, 87 Harv. L. Rev. 1786, 1817 (1974).

> the principle of full or absolute priority. . .' Hence . . . there is little or no basis for issuing new participations for vague hopes, especially in a proceeding in which there is no guaranty of an independent assessment of the role of old management or controlling stockholders . . . in bringing the enterprise to insolvency.

The Commission proposal was rejected by Congress. In its place Congress inserted the unambiguous absolute priority rule of 11 U.S.C. § 1129(b)(2)(B).

> The general principle of [section 1129(b)] . . . permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 413, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6369.

In choosing to read into the Bankruptcy Code the rejected Commission proposal, the Eighth Circuit has usurped the legislative power of the Congress.

Indeed, the purpose of providing for the section 1111(b) conversion of a non-recourse claim to a recourse claim and then providing absolute priority for the unsecured class under section 1129(b)(2)(B), was to overrule cases under Chapter XII of the former Bankruptcy Act, such as *In re Pine Gate Assoc., Ltd.*, 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976), under which the non-recourse mortgagee was paid the value of the collateral while the debtor kept the property. *Ahlers* would produce a result similar to, but even more burdensome than that which Congress intended to avoid (*Pine Gate* dealt only with non-recourse debt while *Ahlers* would apply to both recourse and non-recourse debt and *Pine Gate* provided that the mortgagee receive the collateral value in cash, rather than a mortgage with a face amount equal to the value of the collateral as in



*Ahlers*) and is obviously contrary to the intent of Congress. *See, e.g.*, Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. Law. 441 (1984); L. Cherkis, *Collier Real Estate Transactions and the Bankruptcy Code* § 1.11 (King ed. 1986), and S. Rep. No. 989, 95th Cong., 2d Sess. 65, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5851 commenting on section 502(i), an earlier version of 11 U.S.C. § 1111(b).[4]

Thus it would seem clear that Congress specifically intended the unambiguous call for absolute priority found in section 1111(b) of the Bankruptcy Code. Recently Congress reaffirmed the absolute priority requirement of Chapter 11 by the enactment, as part of the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, of a new Chapter 12 to the Bankruptcy Code on October 3, 1986. H.R. 5316, 99th Cong., 2d Sess. (1986). Chapter 12 deals with an emergency condition faced by certain "family farmers" as defined therein, and will expire at the end of seven years if not renewed. *See* §§ 251 and 302(f) of Chapter 12. Chapter 12 provides for a modification of the absolute priority rule by limiting the recovery of the mortgagee on its unsecured claim to the amounts unsecured creditors would receive if there had been a Chapter 7 liquidation. Since, under current conditions in the farm belt, it is unlikely that unsecured creditors will receive payments in a presumed liquidation, and thus unlikely that they will receive payments under the plan, the result to the debtor under Chapter 12 will be similar to *Ahlers* in that the debtor will be able to keep the property with the mortgagee relegated to a mortgage with a principal balance equal to the value of property. If the *Ahlers* interpretation of absolute priority (which would

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[4] *See* the more complete discussion of this Congressional purpose in the Brief, *amicus curiae* of the American College of Real Estate Lawyers.

apply to all debtors under Chapter 11) were correct, there would have been no necessity to enact Chapter 12 for family farmers. Indeed, the inability of the family farmer to satisfy the unsecured claim under 11 U.S.C. § 1129(b)(2)(B) was the *raison d'etre* for Chapter 12. *See* 132 Cong. Rec. S15075 (daily ed. Oct. 3, 1986) (statement of Senator Grassley).

In summary, the *Ahlers* decision is contrary to the language of Chapter 11, the intent of Congress and the case it cites for support of its conclusions. It should be reversed.

## II. THE EIGHTH CIRCUIT MISINTERPRETED SECTIONS 361 AND 362(d)(1) OF THE BANKRUPTCY CODE, 11 U.S.C. §§ 361 AND 362(d)(1).

### A. Postponement of adequate protection payments are contrary to the statutory language and Congressional purpose.

In *Ahlers*, the court below held that adequate protection when required by § 362(d)(1) of the Bankruptcy Code, should be postponed for a period equivalent to the time it would have taken for the mortgagee to foreclose and be able to sell the collateral free of redemption rights, which period in Minnesota "at the earliest" (794 F.2d at 396) would be one year and 60 days. This vitiates the protection for secured creditors provided by 11 U.S.C. §§ 362(d)(1) and 361.

Clearly the automatic stay is an essential protection for debtors and creditors, and affords a method that permits the orderly administration of the nation's bankruptcy machinery. Congress, however, recognized that during the period of the stay, creditors with interests in the debtor's property could be hurt by the diminution of the value of those interests, and for both constitutional and policy reasons,[5] provided in 11 U.S.C. § 362(d)(1)

[5] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 339, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6295; S. Rep. No. 989,



that relief from the stay must be granted if adequate protection for such loss is not afforded. Alternative forms of adequate protection are set forth in 11 U.S.C. § 361.

Were it not for the stay, the mortgagee might have begun the foreclosure process on the day it requested relief from the stay or before. Certainly the foreclosure may take a great deal of time. In many jurisdictions it takes years, often longer than any anticipated bankruptcy proceedings, especially where judicial foreclosures are involved. *See* G. Nelson & D. Whitman, *Real Estate Finance Law* 505 (2d ed. 1985). Yet Congress did not suggest that commencement of adequate protection should be delayed for such a period. Rather, there was a recognition that with each day the mortgagee is precluded from beginning the foreclosure process, another day will be added at the end before the mortgagee can conclude that process: another day during which the collateral can continue to diminish in value; another day during which taxes will continue to accrue and prime the lien; another day for a prospective purchaser of the mortgage to discount the price it will pay; and another day during which the mortgagee will continue to lose the time value of its investment. Adequate protection was designed to protect the mortgagee against these losses. Yet under the Eighth Circuit's decision, that protection will be eliminated.

In discussing the purpose of adequate protection, Collier on Bankruptcy states:

> The most important message of the Code with respect to the treatment of entities with an interest in

95th Cong., 2d Sess. 49, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5835; *Louisville Joint Stock Land Bank* v. *Radford*, 295 U.S. 555 (1935); *Wright* v. *Vinton Branch of Mt. Trust Bank*, 300 U.S. 440 (1937); *Wright* v. *Union Central Life Ins. Co.*, 311 U.S. 273 (1940); and *United States* v. *Security Ind. Bank*, 459 U.S. 70 (1982).

> property of the estate is that their remedies may be suspended, even abrogated, their right of recourse to collateral may be terminated as it is consumed in the business, but the value of their secured position *as it existed at the commencement of the case is to be protected throughout the case.*

2 Collier, *Bankruptcy* § 361.01 (15th (L. King) ed. 1986) (emphasis added).

It is the very value of the secured position as it existed at the commencement of the case that the Eighth Circuit in *Ahlers* denies to the secured creditor. Rather the court determines that the start of this protection must be postponed to a period which may very well exceed the length of the bankruptcy proceeding. This makes illusory the adequate protection built so carefully into the Bankruptcy Code and deprives the creditor of money and property rights without an indubitably equivalent substitute required by 11 U.S.C. §§ 362(d)(1) and 361 and expressed so eloquently by Judge Learned Hand in *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). The holding appears to be another example of an attempt to gain by judicial interpretation what Congress has rejected.

### B. Delaying adequate protection payments based on the debtor's contingent expectation of income in the future constitutes a shifting of the entrepreneurial risk to the secured creditor and denies the secured creditor the benefit of the bargain in violation of the adequate protection requirement of the Bankruptcy Code.

Congress intended that adequate protection "insure that the secured creditor receives in value essentially what he bargained for." H.R. Rep. No. 595, 95th Cong., 1st Sess. 339, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6295. Section 361 of the Bankruptcy Code provides that adequate protection includes "periodic cash payments." The court below found that it was improper for the bankruptcy court to rule that adequate protection payments should be made monthly when the debtor, a farmer, would realize income, if at all, when the crops are grown and sold. While monthly payments might be accumulated (794 F.2d at 397 n.11), the court held that they may not, as a matter of law, be required to be paid until harvest at the end of the growing season.



This requirement of the Eighth Circuit subverts the very purpose of providing adequate protection and shifts the entrepreneurial risk of the farming operation from the debtor to the secured creditor. The ordered payments are clearly contingent and based on expectations that have no assurance of being realized. The ability of the debtor to make the payments at the end of the growing season will be subject to the ability to harvest and sell a crop, which in turn may be frustrated by blight, infestation, drought, storm, heat, cold, market conditions, and a host of other contingencies. The mortgagees then, already having waited one year and 60 days during which their interest in the collateral may have declined substantially, and having been awarded prospective adequate protection at the end of his time, must then wait to receive payment when and if the crops are harvested and sold. If the debtor does not have the funds at harvest time to make the accumulated payment, then, presumably, relief from the stay will be granted so that the mortgagee can acquire, after another year and 60 days, property of greatly diminished value, without having received any compensation for the loss of the property value or the use of funds.

The Bankruptcy Code provides that the secured creditor can be prevented from realizing on its collateral as long as it receives adequate protection, not as long as it receives whatever adequate protection the debtor may be able to pay. This shifting of the entrepreneurial risk of the debtor's business to the secured lender represents a judicial rewriting of the Bankruptcy Code and should be rejected.

In the drafting of the Bankruptcy Code, Congress considered a proposed section 361 that would have validated the granting of an administrative expense priority as adequate protection. Such protection would obviously have been contingent on assets being available in the future for payment of administrative expenses. The House Report to accompany H.R. 8200 containing this proposal, cautioned that the administrative expense was to be used as adequate protection "only where there is a relative certainty that administrative expenses will be able to be paid in full in the event of liquidation." H.R. Rep. No. 595, 95th Cong., 1st Sess. 340, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6296. Nevertheless, "relative certainty" was not sufficient for Congress and not only was the provision deleted but language inserted in 11 U.S.C. § 361(3) stating that an administrative expense priority is not a proper method of providing adequate protection. In *Ahlers* the Eighth Circuit subjects the secured creditor to the same type of contingency, and shifts to the secured creditor the same type of entrepreneurial risk that gave rise to the Congressional rejection of the administrative expense priority as adequate protection, thus distorting the meaning and application of 11 U.S.C. §§ 361 and 362(d)(1).

By postponing entitlement to adequate protection for a period equal to the time for foreclosure to take place and redemption rights to expire, and by postponing payments to the time the debtor expects to earn income in the future, the Eighth Circuit has severely crippled the effectiveness of adequate protection provisions of the Bankruptcy Code, frustrating the policy of Congress and the Fifth Amendment Constitutional protections for secured creditors.



## III. CERTIORARI SHOULD BE GRANTED TO RESOLVE A MAJOR QUESTION OF INTERPRETATION OF A FEDERAL STATUTE THAT HAS SIGNIFICANT IMPACT ON LENDERS, BORROWERS AND THE ECONOMY OF THE NATION.

### A. The *Ahlers* misconstruction of Chapter 11 of the Bankruptcy Code applies to all cases under that Chapter and is not limited to insolvencies of farmers.

While *Ahlers* involved a farmer, and the present plight of farmers may have been a motivating factor in the Eighth Circuit's desire to enable the debtor to keep the farm within the strictures of Chapter 11, it is clear that the rules and principles laid down by the Eighth Circuit apply with fine impartiality to all cases under Chapter 11.

Thus the real estate developer in Chapter 11, whose mismanagement may have been the cause of the failure, can in the Eighth Circuit, and in any other bankruptcy court sympathetic to debtors, by promising to continue the past inadequacies, keep the property while the mortgagee's unsecured claim remains unpaid. Real estate partnerships can, by filing in Chapter 11, effectively reduce their mortgages to the value of the collateral while continuing to operate the property.

Corporations in Chapter 11 can now propose, and have confirmed, plans under which old stockholders by promising to provide the reorganized company with continuity of management, their business contacts, their stature and influence in the financial community, or a "host" of other "intangibles," obtain an interest in the reorganized company without compensating unsecured creditors, and easily evade "the principle of full or absolute priority" mandated by the Bankruptcy Code and this Court's decision in *Los Angeles Lumber*.

**B. The *Ahlers* misconstruction of Chapter 11 of the Bankruptcy Code, now the law of the Eighth Circuit, will be raised in numerous Chapter 11 cases throughout the country, resulting in increased litigation costs and raising significant questions of the meaning and uniform application of a major Federal statute.**

*Ahlers* makes major changes in what was understood by the courts and parties subject to being affected by Bankruptcy proceedings to be the meaning of 11 U.S.C. §§ 1129(b)(2)(B), 361 and 362(d)(1). These changes do not affect just a small number of cases. They attack the very heart of the reorganization process—the meaning of cramdown and adequate protection.

The holding is now the law of the Eighth Circuit. Until a holding by each of the other Circuits, trustees and debtors in possession will be virtually constrained to raise the *Ahlers* issues in each Chapter 11 case in the other circuits, with the consequent legal expense and crowding of the calendars of the courts already strained to the breaking point [6] and with differing results throughout the country [7] thus depriving parties affected by Bankruptcy proceedings of the possibility of uniform enforcement of Federal law.

The Council strongly believes that *Ahlers* was wrongly decided. If this is correct, then creditors in the Eighth Circuit and in bankruptcy courts elsewhere that follow *Ahlers* will receive treatment contrary to the law and the intention of Congress. If it is not correct, then debtors will be treated unfairly in the many jurisdictions throughout the country that undoubtedly will reject *Ahlers*. All parties involved in Chapter 11 proceedings will be affected by the uncertainty as to what a

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[6] *See* J. Dahl & C. Mitchell, *Beleaguered Bench: Judicial Resignations, Swollen Caseload Beset U.S. Bankruptcy Court*, Wall St. J., Dec. 9, 1986 at 1, col. 6.

[7] *See, e.g., In re Stegall*, 64 Bankr. 296 (Bankr. C.D. Ill. 1986) where the court emphatically rejects *Ahlers*.



filing in Chapter 11 means. All are entitled to a quick resolution of the meaning of this statute, so important to the national economy.

**C. The insurance industry with over $170 billion invested in mortgage loans, and over 150 million policyholders, as well as other lenders relying on legitimate expectations in connection with mortgage investments, will be severely and negatively impacted by *Ahlers*.**

The insurance industry has invested over $170 million of the funds of over 150 million policyholders, pension customers and others in real estate mortgages, based on the reasonable expectation that the collateral will be available to satisfy the mortgage indebtedness when and if the borrower is unable to pay the debt service. Notwithstanding this, the insurance industry, and other lenders, recognize that in bankruptcy reorganizations they may not be able to realize on the collateral directly, but understand that in such event, they would be protected by adequate protection payments during the period of the reorganization and by a reorganization plan that would afford absolute priority to both their secured and unsecured claims. Had it not been for those reasonable expectations, many of the loans would not have been made, and those that might have been made would most probably have been only at higher interest rates and to borrowers of the highest credit standing. *See* Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 112 (1984).

If the *Ahlers* result should be sustained, it would cause a reduction in the quality of the mortgage portfolio of every lender, result in what might be significant losses, and subject borrowers to stricter credit tests and higher interest rates. Traditionally real estate has been

able to serve as the basis for those borrowers without adequate credit standing to raise funds. With these funds they have built major developments and new businesses, creating new jobs and expanding the nation's economy. It is for those borrowers as well as the lenders that the policy decisions were made that resulted in the cramdown and adequate protection language of the Bankruptcy Code, which language is being attacked by the *Ahlers* decision. It is those borrowers who would be most hurt by the decision below, a decision which, if not quickly resolved, can only have an adverse and abiding negative impact on the national economy and the spirit of entrepreneurship upon which this country was built.

## CONCLUSION

For the foregoing reasons and for the additional reasons advanced in the Joint Petition, the writ of certiorari should be granted.

Respectfully submitted,

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# AMICUS CURIAE

# BRIEF

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No. 86-958

In The
# Supreme Court of the United States
October Term, 1986

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

## BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITIONERS JOINT PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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## BRIEF AMICUS CURIAE OF THE NEBRASKA BANKERS ASSOCIATION, INC.

### INTRODUCTION

The purpose of this brief amicus curiae is to express support for the joint petition for writ of certiorari filed herein and to assist the Court in its resolution thereof by indicating to the Court the adverse public policy consequences of the decision rendered by the United States Court of Appeals for the Eighth Circuit.

### NATURE OF INTEREST OF AMICUS CURIAE

The Nebraska Bankers Association, Inc., (the "NBA") is a trade association having as its members 430 of the 435 commercial banks in Nebraska. Member banks of the NBA serve as the principal providers of credit to individuals, businesses and agricultural entities in the State of Nebraska. Lending decisions by member banks have historically been made with consideration given to the application of the Bankruptcy Code and its effect on the banks legal rights should a borrower elect to file a Chapter 11 Bankruptcy. Heretofore, lending practices of Nebraska banks have been guided by the fact that adequate protection would be available to secured creditors in the event that relief from an automatic stay was not granted and the debtor was allowed to remain in possession of the secured party's collateral. These lending practices have

further been predicated upon the refusal of bankruptcy courts under well established legal principles to permit a debtor to retain an equitable ownership interest in the debtor's property and participate in the reorganization plan ahead of unsecured creditors, who have a senior interest in the estate, in the absence of full payment to unsecured creditors.

The decision of the United States Court of Appeals for the Eighth Circuit and the denial of the petition for rehearing en banc for which the joint petition for Writ of Certiorari is requested is of major importance to the NBA, not only due to its impact in this particular case but also because of the uncertainty that it will cause its member banks to face in extending credit in the future. The existence of unnecessary delay in providing adequate protection to lenders in bankruptcy proceedings will most certainly jeopardize the value of a lender's collateral and inject further caution into the decision to extend credit to business and agricultural customers. The resulting restrictions on the availability of credit come at a time when the business and agricultural communities can least afford it. A similar effect will result from the overthrow of the well-established rule of priority set forth in 11 U.S.C. § 1129(b)(2)(B) as mandated by the decision of the Court of Appeals.

The NBA feels an obligation as the industry most directly affected by the Court of Appeals decision to express its support for the Petitioners' joint writ for certiorari and files this brief, *amicus curiae,* with the consent of the parties pursuant to Rule 36.1 of this Court.

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## ARGUMENT

### I. THE COURT BELOW VIOLATED ESTABLISHED LEGAL PRINCIPLES OF ABSOLUTE PRIORITY UNDER 11 U.S.C. § 1129(b)(2)(B) BY HOLDING THAT A BANKRUPTCY DEBTOR, BY A MERE PROMISE OF FUTURE LABOR, EXPERIENCE AND EXPERTISE, MAY RETAIN OWNERSHIP OF THE REORGANIZED ENTERPRISE WITHOUT PAYING DISSENTING CREDITORS IN FULL.

Sound public policy and strong consideration of the currently depressed farm economy dictate that an equitable balance between the rights of creditors and debtors be reached so that the free-flow of credit in commercial business and agricultural transactions may be maintained. However, the decision of the Court of Appeals in the above proceedings has thrown the rights of creditors and debtors completely out of balance.

While couched in terms of compassion and sympathy, the Court's ruling has served to destroy the reasonable commercial expectations of lenders in entering into financial transactions and has transferred a majority of the risk of loss from farm debtors to their creditors. In establishing new public policy by judicial mandate in the area of Chapter 11 reorganization bankruptcies, the Court has effected an unwarranted intrusion into an area traditionally and more appropriately left to our legislative bodies. In the process, the plain meaning of established statutory provisions have been ignored and well established bankruptcy precedents have fallen by the wayside.

The feared result of this judicial policy-making is the further restriction of farm credit and increases in the cost of obtaining agricultural loans at a time when it can least be afforded.

### A. THE PROVISIONS OF 11 U.S.C. § 1129(b)(2)(B)(ii) AND THE LEGISLATIVE HISTORY BEHIND THAT SECTION PRECLUDE ANY JUDICIAL EXPANSION OF THE ABSOLUTE PRIORITY RULE TO INCLUDE EXPERIENCE, KNOWLEDGE AND LABOR AS CAPITAL CONTRIBUTIONS.

The provisions of 11 U.S.C. § 1129(b) set forth that a plan of reorganization *cannot* be confirmed over the dissent of a class of unsecured claims unless those claims are paid in full, or in the alternative, that no junior interest holder, whether stockholder, partner or sole proprietor, may receive or retain any property under the plan on account of such interest. This section which establishes the so-called "absolute priority rule" requires that a plan of reorganization be fair and equitable before being considered for confirmation.

The court below established a "modified version" of the traditional absolute priority rule by holding that there may be circumstances under which the absolute priority rule can be modified to allow participation by a junior class, even though senior creditors are paid less than their full claims. This act of judicial juggling has resulted in the use of a farmer's experience, knowledge and labor as capital equivalents for purposes of allowing the confirmation of a plan of reorganization, notwithstanding the dissent of unsecured creditors.

In essence, the Court has performed a bit of judicial magic by creating an exception to 11 U.S.C. § 1129(b)



where none exists. The plain meaning of the statute and the legislative history surrounding the adoption of 11 U.S.C. § 1129(b) provides no basis for such an exception.

In 1970, Congress established the Commission on Bankruptcy Laws. In July of 1973, the Commission submitted its report and findings to Congress, and in addition, submitted proposed legislation. After tracing the history of the absolute priority rule, the Commission determined that the rule was deficient. The Commission recommended that the rule be relaxed and modified "by allowing stockholders to participate if their future contribution, i.e. continued management, is essential to the business." Report of Commission on Bankruptcy Laws of the United States, H.R. Doc. 137, 93d Cong. 1st Session 254 (1973). Such provisions, intended to "relax" the absolute priority rule, particularly in terms of delayed participation and participation based upon future management were severely criticized at public hearings conducted by the Commission, and were deleted from the Legislation which was ultimately adopted.

Section 1129 defines the term "fair and equitable". The plain language of this statutory provision does not contain any exceptions for participation by stockholders or owners in the absence of full payment to unsecured creditors. Chapter 11 permits a "cramdown", but the owner or junior interest holder cannot force a dissenting class of unsecured claims to accept less than full payment and at the same time retain his property and any future going concern value.

The tradeoff for the ability of a debtor to use cramdown is a rule that the owners or stockholders cannot par-

ticipate if the cramdown is for less than full payment. This is the balancing of interests as reflected by Congress which recognizes the basic priority of creditors to the assets of the business over the interest of the owner or stockholders. That balance permits the owner or stockholder to participate if they can get a majority of creditors to accept the proposed plan and precludes participation if unsecured creditors are not paid in full. A relatively simple and fair balancing of interests until disturbed by the decision of the lower court. If the majority of creditors do not accept the plan, then "fairness" is violated if the owner/stockholders, the same owner/stockholders who managed the business into bankruptcy to start with, participate in the absence of full payment to creditors.

The lower court's decision has cast uncertainty into this vital issue of federal bankruptcy law. The decision below runs counter to the express language and legislative history underlying 11 U.S.C. § 1129(b)(2)(B)(ii), and contradicts a long line of case law in other Circuits which have addressed this issue. The petitioners' writ for certiorari should therefore be granted to allow this Court to review the propriety of a decision which allows a debtor, whose management skills contributed to a bankruptcy proceeding, to retain his property and benefit at the expense of his creditors by promising future labor, service and management.



## II. THE DECISION BELOW THAT A DEBTOR IN BANKRUPTCY MAY AVOID LIFTING OF THE AUTOMATIC STAY WITHOUT PROVIDING ANY PAYMENT OR ADEQUATE PROTECTION TO SECURED CREDITORS UNTIL SUCH TIME AS THE CREDITORS OTHERWISE WOULD HAVE OBTAINED THEIR COLLATERAL AND SOLD IT FREE AND CLEAR OF ANY RIGHTS OR REDEMPTION IS CONTRARY TO THE BANKRUPTCY CODE'S REQUIREMENTS FOR ADEQUATE PROTECTION, CONFLICTS WITH VIEWS OF OTHER CIRCUITS, AND VIOLATES THE RIGHTS OF SECURED CREDITORS IN BANKRUPTCY.

A fundamental concept underlying the Bankruptcy Code and upon which many lenders have relied in extending credit and taking back security for loans, is that a secured creditor may be stayed from proceeding against its security, and a debtor allowed to use cash collateral *only on the condition* that the creditor is provided adequate protection against impairment of the value of its security interest during the pendency of the stay. The Court below has eroded the adequate protection provisions of the code, effectively doubling the period of time during which a debtor may use its collateral before a lender may realize upon and reinvest the collateral.

The concept of "adequate protection" of a secured creditors' rights arises from the Bankruptcy Codes' attempts to balance the goals of promoting debtor reorganizations by allowing a debtor to use property subject to a security interest while at the same time ensuring that the value of a secured creditor's interest will not be impaired. Substantial delays in a creditor's right to "adequate pro-

tection" upsets the goals of balancing these interests to an extent far beyond that contemplated by the edequate protection provisions of the Bankruptcy Code.

The lengthy delays entailed in the commencement of a lender's right to adequate protection under the lower court's ruling will inevitably increase the risk of loss to secured creditors. This will have a substantial impact on the lending practices in all segments of the financial industry, including commercial banks. The likely result will be to greatly increase the cost of credit to partially compensate the lender for the additional risk exposure. For these reasons, this Court should grant Petitioners' Writ for Certiorari.

## CONCLUSION

If the petitioners' joint petition for Writ of Certiorari is denied and the decision of the lower court allowed to stand without further review, it will have a significant adverse impact on the cost and availability of both agricultural and commercial credit in Nebraska and other states in the Eighth Circuit. The decision will allow bankrupt debtors with no other hope for survival to avoid their creditors at the expense of other farm and commercial borrowers and at the expense of creditors who relied on the plain language of the bankruptcy code and court precedent in extending credit. The court below has ignored the proper roles to be played by the legislative and judicial branches of government at a time when



careful consideration of, and meaningful solutions to the agricultural crisis are most needed.

The issues presented are serious and of grave concern for all creditors in Chapter 11 Bankruptcy Proceedings, and the amicus curiae respectfully requests that the petitioners' joint petition for writ of certiorari be granted.

DATED: January 19, 1987.

Respectfully submitted,

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# AMICUS CURIAE

# BRIEF

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No. 86-958

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October Term, 1986

NORWEST BANK WORTHINGTON and
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*Petitioners,*

vs.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF OF THE AMICUS CURIAE SAVINGS LEAGUE OF MINNESOTA IN SUPPORT OF THE PETITIONERS

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF OF THE AMICUS CURIAE SAVINGS LEAGUE OF MINNESOTA IN SUPPORT OF THE PETITIONERS

This brief *amicus curiae* is filed by the Savings League of Minnesota ("League") with the consent of the parties pursuant to Rule 36.1 of this Court.

## INTEREST OF AMICUS CURIAE

The League is comprised of 37 member savings and loan associations in Minnesota which are engaged in the business of mortgage lending to finance the purchase, construction and improvement of commercial, industrial and residential real estate properties. League members are frequently involved as secured and partially secured creditors in Chapter 11 cases and regularly face the same issues as those presented by the petitioners Norwest Bank Worthington ("Norwest") and the Federal Land Bank of St. Paul ("Federal Land Bank").

The League supports the joint petition of Norwest and Federal Land Bank because of importance of the issues to the administration of Chapter 11, the necessity to resolve conflicts with the decisions of the Supreme Court and other Courts of Appeal, and because of its conviction that the panel majority of the Court of Appeals has judicially abrogated both the concept of adequate protection as a condition for continuing the automatic stay of 11 U.S.C. § 362 and the settled rule of absolute priority of 11 U.S.C. § 1129(b)(2)(B)(ii).

In the event certiorari is granted, Norwest and the Federal Land Bank have reserved a procedural question challenging the basis on which the Court of Appeals reversed key fact findings by the bankruptcy and district courts. The League believes this question deserves the full scrutiny of the Supreme Court on its merits; the Court of Appeals has exercised de novo review of the facts contrary to established principles of limited appellate review which threatens to encourage destructive delays in the administration of the Bankruptcy Code.

The joint petitioners have also asked the Court to review the rehearing procedure of the Court of Appeals which resulted in denying rehearing despite a 5-4 vote in favor. The



issue has already become a matter of widespread concern as illustrated by the 1984 American Bar Association Journal article "The Breakdown in Federal Appeals," ABA Journal, Vol. 70, p. 56, February 1984. The question deserves full review in the interest of all involved in the federal judicial process.

## SUMMARY OF ARGUMENT

### I.

The Court of Appeals erred by failing to acknowledge any protectable interest of a foreclosing creditor during the notice and redemption period provided by state real estate foreclosure laws. The error below was compounded by the fact that it necessarily at least doubles the period of time that a foreclosing real estate creditor must endure before it can gain unencumbered possession of its collateral while suffering in the interim further diminution in the value of the collateral and the continued lost opportunity to reinvest the proceeds of sale of the collateral.

### II.

The Court of Appeals erred in determining that the debtor should be permitted continued use and enjoyment of the property under a plan of reorganization despite the unambiguous provisions of 11 U.S.C. § 1129(b)(2)(B)(ii) requiring that unsecured creditors be paid in full before the debtor or stockholders receive or retain anything under a plan. The key error was the conclusion of the Court of Appeals that the debtor's continued "labor experience and expertise" are the equivalent of a contribution of "money or money's worth" within the meaning of *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

## ARGUMENT

The fact that this Chapter 11 case arises in the context of a distressed farm economy is a happenstance. However, the panel majority of a Court of Appeals has permitted its understandable concern about this special problem to obscure the fact that the impact of the decision will be felt most acutely in the majority of Chapter 11 cases which involve non-agricultural enterprises. Whether Chapter 11 was adequate or inadequate to accommodate the special needs of the troubled farm economy—as the Court of Appeals appears to have questioned—was a decision to be made by Congress, not the judiciary. Indeed, following the Court of Appeals decision, Congress effectively removed most farm reorganization cases from Chapter 11 with the 1986 enactment of the new Chapter 12 because of similar concerns. Paradoxically, therefore, the damage done by the Court of Appeals' decision will now be felt primarily in non-farm cases in which the concerns in motivating the Court of Appeals are inapplicable.

Chapter 11 has become a major economic determinant; its proper administration will be hobbled unless this Court grants certiorari to resolve the questions presented by the joint petitioners.

### THE COURT OF APPEALS HAS EVISCERATED THE ADEQUATE PROTECTION REQUIREMENTS OF THE BANKRUPTCY CODE AS THEY RELATE TO CREDITORS SECURED BY REAL ESTATE

One feature of the lower court's decision deserves special mention, particularly as to the rights of creditors secured by real estate.

This case presents the common scenario of a Chapter 11 petition filed before a real estate secured creditor has been



able to commence or complete foreclosure proceedings under state law. The timing of Chapter 11 petitions is in the sole control of the debtors and petitions are often filed in anticipation of foreclosure or after commencement of foreclosure by notice but before the foreclosure sale can be held. Upon filing the petition, the automatic stay of 11 U.S.C. § 362(a) effectively negates incomplete foreclosure proceedings and prohibits the secured creditor from commencing or recommencing foreclosure under state law unless and until the stay is terminated. But it must be emphasized that as long as the stay is in effect the state law redemption period following a foreclosure sale cannot begin because the creditor cannot start the process. If the stay is subsequently terminated, the effect is merely to remove the federally imposed restraint upon the creditor, but the creditor cannot obtain possession of its collateral until it first complies with state law and then waits for the redemption period to expire following the foreclosure sale.

The Court of Appeals as a matter of law postponed the entitlement and calculation of adequate protection payments required under § 362(d) to a future date coincident with the expiration of the redemption period. The court assumed hypothetically that the secured creditor had commenced foreclosure on the date of the original application to terminate the § 362 stay, and opined that the creditor would have no interest of realizable value until the redemption period expired. The necessary effect of this holding is to automatically deny any motion to terminate a stay until, in the case of Minnesota farm real estate, at least six weeks and one year (the notice and redemption period of state law) after the creditor's motion.

The Court of Appeals either ignored or failed to realize that during this federally imposed postponement, the state law redemption period is in fact *not* running because the continua-

tion of the automatic stay prevents the secured creditor from beginning the foreclosure process under state law.

At the end of that period, according to the lower court, the Bankruptcy Court would then take up the issue of adequate protection payments as a condition of further continuance of the automatic stay. At that point those payments would necessarily have to include amounts sufficient both to compensate the creditor for its continued lost opportunity to reinvest the liquidation value of its collateral and demonstrable diminution in the value of the land. Given the distressed circumstances inherent in most Chapter 11 cases, it is unlikely that the debtor could make those payments and the stay would ordinarily then be lifted. But the result at that later time would only be to allow the creditor to begin the state law foreclosure process which would then, but only then, actually commence the notice and redemption period compelled by state law before the creditor can gain unencumbered title to the property. The result is to at least double the period of time in which the creditor suffers the unrecoverable loss of reinvestment opportunity and the decline in land values.

This result may have been inadvertent since it collides with some of the basic reasoning of the decision below but, inadvertent or not, it is a violent contradiction of the concept of adequate protection.

The joint petitioners and other amici have already pointed out the Court of Appeals' erroneous assumption that a foreclosing creditor does not have any interest of value during the redemption period that needs to be protected. Those arguments will not be repeated here.



## THE COURT OF APPEALS HAS NEGATED THE ABSOLUTE PRIORITY RULE GOVERNING APPROVAL OF PLANS OF REORGANIZATION

There is no room in 11 U.S.C. § 1129(b)(2) for approval of a plan of reorganization where objecting unsecured creditors who are not to be paid in full are to be subordinated to the owners or stockholders of a Chapter 11 debtor. Yet, this is precisely what the Court of Appeals has done by equating a debtor's "labor, experience and expertise" with "money or money's worth" as that test was formulated in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

The *Los Angeles Lumber* formulation of "money or money's worth" expressly contemplated a "*fresh* contribution," by the owners, i.e., money or productive assets of the type that appear on the asset side of a balance sheet. *See* 308 U.S. at 121. In such a case, the unsecured creditor's interests, such as they are before the injection of the "fresh contribution," are not diminished if the owner's participation in the plan is equal to the value of the fresh contribution and "no objection can be made [by the senior creditors]" 308 U.S. at 121. But there is nothing new about an owner's labor, expense or alleged expertise. An enterprise in Chapter 11 has, by definition, become impaired either because of or in spite of the owner's "labor expense and experience," and a continuation of that which enterprise has always had is not a "fresh contribution" of anything, much less money or money's worth.

The Court of Appeals clearly invites every owner of a Chapter 11 debtor to subordinate unsecured creditors by the simple expedient of promising his or her continued personal efforts in running the business. The lower court's description of the requirement of "money or money's worth" as merely a contribution which is "reasonably compensatory and measur-

able" (A-24) is an artful but impermissible judicial abrogation of the mandate of the statute and cannot be justified any longer—if it ever could—by invoking concerns over the adequacy of Chapter 11 in farm reorganization cases.

## CONCLUSION

The impact of the Court of Appeals' decision will be felt primarily in non-farm Chapter 11 cases. Too often, Chapter 11 is invoked unrealistically by debtors whose problems have gone beyond any hope of recovery, as was the case here. The Court of Appeals has unfortunately granted to such debtors additional means with which to forestall the inevitable to the detriment of creditors. The statutory balance of the legitimate needs of the debtor and the rights of the creditors has been severely disturbed. Moreover, the assumption by the Court of Appeals of virtual de novo review jurisdiction is a clear invitation to litigants to increase the delay and already considerable expense of all bankruptcy cases.

The amicus League urges the Court to grant certiorari to restore the integrity of the Bankruptcy Code.

Dated: January 21, 1987.

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# AMICUS CURIAE

# BRIEF

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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v.

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*Respondents.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## MOTION FOR LEAVE TO FILE A BRIEF AND BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITION

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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**No. 86-958**

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*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

---

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

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## MOTION FOR LEAVE TO FILE A BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITION

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In accordance with the provisions of Rule 36 of the Supreme Court Rules, the American Bankers Association hereby respectfully moves the Court for leave to file the attached brief as amicus curiae in support of the petition. The Petitioners have consented to the filing of this brief; the Respondents have not replied to a request for their consent.

The American Bankers Association is the principal trade association of the commercial banking industry in the United States. There are member banks of the American Bankers Association located in each of the fifty states and the District of Columbia, including banks chartered by the Comptroller of the Currency (National Banks) and banks chartered by the states in which they are located (State Banks).

Almost four thousand commercial banks, primarily small ones, are classified as "agricultural banks," i.e., those with a minimum of 25% of their lending dedicated to the financing of farms or ranches.[1] In recent years, agricultural banking has experienced extreme difficulties. First, a period of rapid inflation in the value of farmland encouraged farmers to borrow (and banks to lend) in order to purchase additional acreage. This period of inflation, ending in 1981, was swiftly followed by an equally rapid decline in the value of farmland.[2] The net effect of the fluctuations has been that many farm borrowers have been unable to pay their debts to lenders, and the lenders have found themselves without adequate security for the loans.[3] Not only have farms themselves failed, but so too have banks which financed them. Of the 138 commercial banks which failed in the United States in 1986, 59 were agricultural banks.[4]

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[1] Federal Deposit Insurance Corporation, *Farm Bank Problems and Related Policy Options* at 8-9 (1986).

[2] *Id.* at 3-4.

[3] *Id.* at 24.

[4] *FDIC Insured Banks That Have Failed Or Been Rescued in 1986* Am. Banker, Jan. 6, 1987, at 14 col. 1.



The bankruptcy laws have the twin goals of protecting debtors and of assuring an equitable distribution of the debtor's assets among creditors, preventing preferences, defeating efforts to secrete property and providing remedies against every act by which a failing debtor seeks an unequal distribution. *Merchants' National Bank v. Sexton*, 228 U.S. 634 (1913). In addition, there is a strong public policy in favor of preserving the safety and soundness of the commercial banking system. *Gunter v. Hutcheson*, 674 F.2d 862, 870 (11th Cir.), *cert. denied* 459 U.S. 826 (1982).

In the case below, the 2-1 panel majority of the Eighth Circuit leaned too far in the direction of furthering one important policy goal, to the derogation of other, at least equally important, policy goals, by making it even more difficult for lenders to enforce their legitimate interests. That is a matter of interest and concern to the banking industry at large. We

therefore respectfully submit that it is appropriate for the Court to consider the views of that industry as expressed by its representative, the American Bankers Association.

Respectfully submitted,

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January 23, 1987



## QUESTIONS PRESENTED FOR REVIEW

1. Whether a debtor's reorganization plan violates the "absolute priority" provisions of the Bankruptcy Code where the senior interests of unsecured creditors will not be paid in full and the debtor retains ownership of the property but contributes no new capital to fund the reorganization.

2. Whether a debtor may use the automatic stay provision of the Bankruptcy Code in order to retain possession and use of collateral without providing adequate protection to creditors against a decline in the value of the collateral.

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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**No. 86-958**

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NORWEST BANK WORTHINGTON, and FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,

*Respondents.*

---

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

---

## BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITION

---

The American Bankers Association respectfully submits this brief as amicus curiae to urge the Court to grant the petition for a writ of certiorari in order to review a decision of a panel of the Eighth Circuit. The court, in that decision, directed the confirmation of a debtor's reorganization plan, even though that plan would violate the "absolute priority" rule of the Bankruptcy Code and would not provide the "adequate protection" to creditors required by statute under the circumstances. In reaching this conclusion, the Eighth Circuit panel majority has placed itself at odds

with controlling precedent laid down by this Court, with the decisions of other Circuits, and even, through a procedural quirk, with the view of a plurality of the Eighth Circuit itself.[1]

## INTEREST OF THE AMICUS CURIAE

The American Bankers Association is the principal trade association of the banking industry in the United States.

Among its members are nearly 4,000 banks which have at least 25% of their loan portfolios dedicated to agricultural lending.

When bankers assess a loan application, they consider a number of factors in order to determine whether to grant the loan at all and, if so, what interest rate to charge for the loan and what maturity. One of the most important considerations for a banker is the ability to recover the amount of the loan by other means if the borrower is unable or unwilling to repay it according to the terms of the contract. Consequently, fully secured loans typically have a lower interest rate and longer maturity than unsecured loans, and a borrower is more likely to receive the loan in the first place if he is able to post an adequate collateral. Bankers are entitled to, and in fact do, rely upon the existing state of the law in order to assess the validity and enforceability of the

[1] The Bank and the Land Bank petitioned the Eighth Circuit to rehear the 2-1 panel decision en banc. Five of the nine judges voting on the petition for rehearing expressed disagreement with the panel decision, but rehearing was denied because a majority of the ten judges of the Eighth Circuit did not vote for it. One judge had recused himself from voting. See Pet. for Cert. p. A-54, A-58.



security interests that they take as a condition for granting the loan. Here, the bank justifiably believed that, even in the event of a bankruptcy of its borrower, its interests would receive adequate protection in one fashion or another because that is what the law provides. It was on this basis that the loans were made. The effect of the Eighth Circuit opinion in this case is to change the rules of the game after the fact.

Since the geographic jurisdiction of the Eighth Circuit encompasses many of the major farm states in the country, it is a particularly significant decision in its own right and may become even more so if it stands unreviewed and unreversed and serves as a precedent to be followed in other jurisdictions. Bankers will be compelled to reevaluate their criteria for granting and pricing future agricultural loans nationwide if the reasoning of the Eighth Circuit must be factored into the determination. That predictable result will be disadvantageous not only to the banks represented here by the American Bankers Association, but also to prospective and actual farm borrowers in the future. Neither the farmers nor the agricultural banks can afford another complication added to an already distressed situation.

## SUMMARY OF ARGUMENT

The reasons for granting a writ of certiorari in this case are well set forth in the Petition. The decision of the Eighth Circuit is inconsistent with the decision of this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), with respect to the interpretation and application of the "absolute priority" rule. It also creates a conflict among the circuits, in that the Sixth Circuit has concluded, contrary to the

decision below, that a debtor's contribution of skill, experience and management of property is not the equivalent of "money or money's worth." *Metropolitan Holding Company v. Weadcock*, 113 F.2d 207 (6th Cir. 1940). For reasons set forth in the preceding section of this brief, we also submit that the case raises an important question of federal law which should be decided by this Court.

We shall not burden the Court by a mere repetition of arguments presented elsewhere. Instead, we respectfully bring to the Court's attention subsequent legislation which has considerable bearing upon the propriety of the Eighth Circuit's decision in this case. As we show in the following section of this brief, the Eighth Circuit wrote the substantive provisions of the Family Farmer Bankruptcy Act into statute before Congress did, and without the various devices designed to protect creditor rights which Congress chose to include in that law. The result creates a legally intolerable conflict between an existing statute (as construed by the Court below) and a new statute, which would lead ambiguity and confusion in any efforts of the bench or bar to apply the two laws.

## ARGUMENT

In his dissenting opinion in the case below, Judge John R. Gibson said that

> [i]f there is to be an adjustment to the relationship between the farmer and the farmer's bank, serious policy questions are presented which can best be considered by the Congress. We, however, are advised to confine our efforts to deciding cases on the law as written and on the facts as found.



(Pet. for Cert., A-36).

Judge Gibson was prophetic to say the least. Four months after the Eighth Circuit's decision in this case, Congress passed and the President signed the Family Farmer Bankruptcy Act of 1986 which, in fact, dealt with the serious questions to which Judge Gibson referred and did in fact adjust the relationship between the farmer and the farmer's bank.

The Eighth Circuit construed provisions of the Bankruptcy Code which were then in effect and which remain in effect now. If the court's interpretation of those still effective provisions is correct, then that law is in direct and irreconcilable conflict with the new Family Farmer Bankruptcy Act. Since it is a cardinal rule of statutory construction that "statutory provisions, whenever possible, should be construed so as to be consistent with each other,"[2] the Eighth Circuit's opinion is untenable.

Section 1129 of the Bankruptcy Code sets forth the "absolute priority" rule in bankruptcy cases. It provides that a reorganization plan cannot be approved over objection by certain creditors unless the interests of those creditors are fully provided for or the plan does not discriminate unfairly and the debtor does not retain any property. 11 U.S.C. § 1129(b)(2)(B)(ii).

Nevertheless, the Eighth Circuit directed the approval of a reorganization plan which permits the farmers here to retain possession of and an interest in the property and participate in the plan because

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[2] *Citizens to Save Spencer County v. U.S. Environmental Protection Agency*, 600 F.2d 844, 871 (D.C. Cir. 1979); *Maiatico v. U.S.*, 302 F.2d 880, 886 (D.C. Cir. 1962).

they would contribute their experience, knowledge and labor to the bankruptcy estate.

The Family Farmer Bankruptcy Act basically achieves the same result. Under that Act, farmers filing under Chapter 12 may retain property even though unsecured creditors are not paid in full and even though they do not approve the plan. The Act eliminates the application of the absolute priority rule to Chapter 12 debtors. Indeed, the legislation was in direct and specific response to complaints that farmers were unable to reorganize under Chapter 11 and instead were forced to liquidate, in large part because of the absolute priority rule that required that the debtor retain no property.[3] The legislators remedied the complaint by eliminating its application to family farmers. 11 U.S.C. § 1203. The debtor can be removed from possession only "for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor" 11 U.S.C. § 1204.

Similarly, Section 361 of the Bankruptcy Code requires that secured creditors receive adequate protection for their interests during an automatic stay. If those interests cannot be adequately protected, the secured creditors are entitled to relief from the automatic stay.

In this case, the creditors sought relief from the automatic stay and the Bankruptcy Court granted the motion, holding that "[i]t is the present value of [the] interest, the opportunities lost, that must be protected." *In Re Ahlers* (Bankr. D. Minn. March 15, 1986) (Pet. for Cert. App. p. A-63).

[3] Anderson, "An Analysis of Pending Bills to Provide Family Farm Debtor Relief under the Bankruptcy Code," reprinted in Cong. Rec. S-15,076, S-15,082 (daily ed. Oct. 3, 1986).



The Eighth Circuit reversed. By stretching out the date of valuation of the property and the beginning date for "adequate protection" payments admittedly for a period of one year and six weeks (*Ahlers v. Norwest Bank Worthington*, Pet. for Cert. App. p. A-12) and, as a practical matter, for two years and twelve weeks (Pet. for Cert. p. 16), the court has deprived the creditors of adequate protection for lost opportunity. As the petition for writ of certiorari points out, the risk of decline in value of the farmland remains entirely on the creditors during this period, while the borrower retains possession and use of the property and all profits received. (*Id.*)

What the Eighth Circuit has read into preexisting law, Congress has now done explicitly with its enactment of the Family Farmer Bankruptcy Act. The new law "modifies the provisions of adequate protection by eliminating lost opportunity cost and the 'indubitable equivalent' language of 11 U.S.C. § 361(3)." Cong. Rec. S15,075 (daily ed. Oct. 3, 1986) (statement of Sen. Thurmond). *See also* Joint Explanatory Statement of the Committee of Conference, Cong. Rec. H8998, H8999 col. 2 (daily ed. Oct. 2, 1986).

In addition, the new law allows family farmers to provide adequate protection in the form of rent payments, substantially reducing the family farmer's burden of adequate protection payments. 11 U.S.C. § 1205(b)(3).

The modifications in the definition of adequate protection apply exclusively to the family farmer. Once

again, the legislation was intended to answer the complaint that farmers were unable to reorganize under the bankruptcy law. As shown above, members of Congress were convinced that a leading factor inhibiting reorganization was the inability of farmers to assure creditors adequate protection of collateral by making payments to undersecured creditors during the period between the filing of the bankruptcy petition and the plan confirmation. (This period is typically much shorter than the one year and six week period allowed by the Eighth Circuit before adequate protection is required. Under the Family Farmer Bankruptcy Act, debtors have only ninety days to file a plan.) If Congress had believed that the adequate protection provision of Section 361 of the Bankruptcy Code allowed the extended period before adequate protection is required that the Eighth Circuit claimed, there would have been no logical reason or jusitification for changing its definition to assist family farmers in making adequate protection payments.

Rather than making this case moot or of interest only to the immediate parties, the coincidental timing of this case and the enactment of new legislation in the subject area creates serious and continuing internal conflict in the Bankruptcy Code, demanding a reconciliation which, at this point, only plenary review by this Court can supply.

Even though the overall approach to the farm crisis taken by the Eighth Circuit under preexisting law in this case and by Congress in its new legislation is essentially the same, the interpretation of preexisting law as equivalent to the new law destroys Congressional intent in a number of major respects.



How can effect be given to the Congressional directive that new Chapter 12 shall be applied to cases filed after November 26, 1986, and not before,[4] if the Eighth Circuit is correct in holding in essence that the substantive provisions of the new law were already part of preexisting law?

How can effect be given to the Congressional intent that new Chapter 12 is designed to be an "experimental" and "temporary" provision of the law (Cong. Rec. S15076 (daily ed. Oct. 3, 1986) (statement of Sen. Grassley)) if the Eighth Circuit is correct in concluding that its substantive provisions are, in essence, already a part of the permanent Bankruptcy Code?

How can effect be given to the Congressional intent that the benefits of new Chapter 12 be limited to "family farmers" as that term is defined in the Act (*Id.*) if the Eighth Circuit is correct in concluding that preexisting law already substantially confers those benefits upon any class of debtors who file for reorganization under Chapter 11 of the Bankruptcy Code?

How can effect be given to the terms and conditions and limits set by Congress as a necessary prerequisite for farmers to take advantage of new Chapter 12 (*Id.*) (*See also*, e.g., 11 U.S.C. § 1208(c)) if the Eighth Circuit is correct in holding that debtors have essentially the same rights under preexistinq law without complying with the new terms and conditions?

The Family Farm Bankruptcy Act was not passed as a "clarification" of existing law but was passed

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[4] *In Re Waetjen*, No. BKY 4-86-3335, slip op. at 2 (Bankr. D. Minn. Nov. 26, 1986).

as "an innovative approach to a crisis . . . an extraordinary response"[5] because the preexisting "Bankruptcy Code doesn't work for farmers."[6] The Eighth Circuit's decision declares the work of Congress to be much ado about nothing. That is an intolerable result and should be overturned.

## CONCLUSION

For all of the reasons stated herein and in the Petition for Writ of Certiorari, the Writ should be granted.

Respectully submitted,

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[5] Cong. Rec. S15,075 (daily ed., Oct. 3, 1986) (statement of Sen. Thurmond).

[6] *Id.* at S15,076 (statement of Sen. Grassley).

# AMICUS CURIAE

# BRIEF

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OCTOBER TERM 1986

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ON WRIT OF CERTIORARI TO THE EIGHTH
CIRCUIT COURT OF APPEALS

# BRIEF AMICUS CURIAE OF THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS IN SUPPORT OF CERTIORARI AND REVERSAL

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A. The Eighth Circuit's decision in Ahlers has no basis in the language of 11 U.S.C. section 1129(b)(2)(B) or in the legislative purpose for which it was adopted, and is contrary to the decision of this Court in Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939)..... 5

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## QUESTIONS ADDRESSED

The questions addressed by the Amicus Curiae are as follows:

1. Is a promise of future labor a present contribution of capital that would enable a debtor to retain an interest in property without compensating unsecured creditors as required by 11 U.S.C. section 1129(b)(2)(B)?

2. Are the adequate protection requirements of 11 U.S.C. sections 362(d)(1) and 361 met if entitlement to protection is postponed for a period equal to what it would have taken to foreclose and obtain possession free of redemption rights?

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## INTEREST OF THE AMICUS CURIAE

The American College of Real Estate Lawyers was organized on April 28, 1980, as a nonprofit corporation for the purpose of gathering together lawyers distinguished for their skill, expertise and high standards of professional and ethical conduct in the practice of real estate law, in order, inter alia, "to improve and reform real estate law and practice" (Articles of Incorporation at 2). Those elected to the College (which has a membership that includes attorneys from every state and the District of Columbia who represent borrowers, lenders, purchasers, sellers, developers and institutional investors) are required to have concentrated their practice in real estate law for a period of not less than ten years. Additional requirements established by the Board of Governors include a demonstrated willingness to

devote time to improving real property law, including writing, teaching or participating in organized bar projects.

This brief supports the Joint Petition for a Writ of Certiorari of the Petitioners. Due to the background of its members, the amicus is particularly qualified to offer to this Court its expertise in the significant real property issues involved in this case and to advise of the serious impact that the holding below could have on real estate bankruptcies, real estate mortgagees, the real estate industry and the economy of the nation.

## SUMMARY OF ARGUMENT

The decision below that a promise of future work entitles the debtor to retain collateral under the plan, while unsecured creditors remain unpaid, has no basis in the language of Section 1129(b)(2)(B) of the Bankruptcy Code, or applicable decisional law. It would violate Congress' clear intention to overcome the Pine Gate line of cases under Chapter XII Of the former Bankruptcy Act, which had produced a result similar to Ahlers.

Postponing entitlement to adequate protection, for the time the court estimates it would have taken to foreclose and obtain possession free and clear of redemption rights, deprives the mortgagee of protection against both declining value of the collateral and lost opportunity costs. Such

postponement is likewise contrary to the language of the Bankruptcy Code and the intention of Congress. During the period of the stay the mortgagee may be subject to loss occasioned by decrease in the value of collateral and lost opportunity costs. The decline in collateral value does not relate to the time it would have taken the mortgagee to be in a position to invest funds realized upon the sale of the property, and adequate protection for this loss should not be postponed for this period. Postponement of lost opportunity costs ignores the fact that the mortgagee will be subject again to the same delay when relief from the stay is eventually granted.

The decision below, if not reversed, will have a severe adverse impact upon mortgage lending.

I

## THE COURT BELOW ERRED IN HOLDING THAT A DEBTOR'S PROMISE OF FUTURE WORK MODIFIES THE ABSOLUTE PRIORITY REQUIREMENTS OF SECTION 1129(b)(2)(B) OF THE BANKRUPTCY CODE (11 U.S.C. SECTION 1129(B)(2)(B)).

A. The Eighth Circuit's decision in Ahlers has no basis in the language of 11 U.S.C. section 1129(b)(2)(B) or in the legislative purpose for which it was adopted, and is contrary to the decision of this Court in Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).

The American College of Real Estate Lawyers supports the arguments presented in the amicus curiae brief of the American Council of Life Insurance and the Joint Petition for a Writ of Certiorari of the Petitioners. By permitting the debtor to retain an interest in the property without fully compensating the dissenting unsecured

creditor class, the decision below clearly violates the unambiguous absolute priority requirements of section 1129(b)(2)(B) of the Bankruptcy Code. It represents an inappropriate application and distortion of the decision of this court in the Los Angeles Lumber and similar cases.

The Congressional intent is clear.

> [U]nder clause (ii) [of 11 U.S.C. section 1129(b)(2)(B)], the court must confirm the plan if the plan provides that holders of any claims or interests junior to the interests of the dissenting class of impaired unsecured claims will not receive any property under the plan on account of such junior claims or interests. ... [T]he plan may be confirmed if the impaired class of unsecured claims receives less than 100 cents on the dollar (or nothing at all) as long as no class junior to the dissenting class receives anything at all.

124 Cong. Rec. S17421 (daily ed. October 6, 1978) (statement of Senator DeConcini)(emphasis added).

The quoted commentary clearly indicates Congress intended to prohibit impairment of the claims of a non-consenting class of unsecured creditors if a junior class of creditors or interests receives anything under the plan. The courts do continue to apply the "new capital" corollary to the absolute priority rule of Los Angeles Lumber. But that corollary does not permit the absolute priority rule to be abrogated based on a contribution of intangible hopes and unenforceable promises having no place on a balance sheet. Los Angeles Lumber, 308 U.S. at 122-23. The holding below that a promise to work in the future constitutes such present capital is inconsistent with this Court's decisions and the language and purposes of the Bankruptcy Code.

Often the cause of the failure of a real estate project is poor management. See e.g., Blumenfeld, Saving Problem Loan and Residential Income Properties, 5 Real Estate Rev. No. 2, 58 (Summer 1975). However, even in the worst of times, while the number of failures increase, many projects continue to be successful. Sometimes this is due to location. More and more often today it is due to management. Deferred maintenance, poor tenant relations and failure to give tenants proper attention frequently cause the down-hill slide. An undertaking to work in the future, by a promisor whose work in the past may have caused the problem, should not be allowed to deprive a mortgagee of its bargained-for rights, contrary to Congressional intent.

B. The decision below deprives the mortgagee of absolute priority for its unsecured claim and thereby undermines the protection for the mortgagee built into the Bankruptcy Code by Congress.

The decision below ignores the intent of Congress that reorganization plans be confirmed only if they are "fair and equitable" as to dissenting impaired classes; that is, unless the principle of absolute priority is observed. This is critical to the real estate industry. Absolute priority for the mortgagee's unsecured claim is the linchpin in the package of protection built into the Bankruptcy Code by Congress to protect mortgagees in this very type of situation.

Absolute priority for the mortgagee's unsecured claim is what prevents the debtor from keeping the property without satisfying the claims of creditors. The

decision below would destroy absolute priority for the unsecured claim based on a debtor's flimsy promise to work in the future. This would permit the court to confirm a Chapter 11 plan under which the debtor gets the property while debts to unsecured creditors (including the unsecured portion of a mortgagee's claim) remain unpaid. The mortgagee would be left with a mortgage reduced to the depressed value of the property, and without compensation for the amount of debt exceeding the value of the property.

Congress intended to avoid such a result when it required absolute priority in section 1129(b)(2)(B). A major purpose of the legislation was to overcome the so-called "Pine Gate" line of cases that would have done to non-recourse mortgagees what Ahlers below would do to all mortgagees. See In re Pine Gate Assoc., Ltd., 2 Bankr. Ct. Dec.

(CRR) 1478 (Bankr. N.D. Ga. 1976). Those cases would, under Chapter XII of the former Bankruptcy Act, have given the mortgaged property to the borrower, while paying the mortgagee the depressed value of the collateral, leaving the mortgagee with no compensation for the amount of the debt exceeding the property value. To overcome this, Congress specifically provided in the Bankruptcy Code that every undersecured mortgagee would be able to have an unsecured claim for the debt in excess of the property value, and that the dissenting unsecured class would be afforded absolute priority. The debtor would thus be unable to keep the property while unsecured debts remain unpaid.[1]

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1 See 5 Collier, Bankruptcy, para. 1111.02[2] (15th (L. King) ed. 1986); L. Cherkis, Collier Real Estate Transactions and the Bankruptcy Code, section 1.11 (King ed. 1985); Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The

(footnote continued)

The legislative history surrounding the Pine Gate controversy is instructive. Prior to the adoption of the Bankruptcy Code, Pine Gate and similar cases under Chapter XII of the former Bankruptcy Act (then 11 U.S.C. §§801-926) had given rise to very grave concern on the part of the real estate industry. Chapter XII dealt with "Real Property Arrangements for Persons other than Corporations." The requirement that a plan had to be "fair and equitable;" that is, that absolute priority was required for confirmation of a plan, had been removed from Chapter XII in 1952 (66 Stat. 435 (1952)) in order to permit debtors to effectuate a plan by "scaling of debts". See S. Rep. No.

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(footnote continued from previous page) Settlement Imperative, 39 Bus. Law. 441 (1984); and S. Rep. No. 989, 95th Cong. 2d Sess. 65 reprinted in 1978 U.S. Code Cong. & Admin. News 5851 (1978), (commenting on section 502(i) of an earlier version of section 1111(b)).

1395, 82nd Cong., 2d Sess. 11 (1952); See also, to the same effect, H.R. Rep. No. 2320, 82nd Cong., 2d Sess. 21, reprinted in 1952 U.S. Code Cong. & Admin. News, 1960, 1982. However, under section 461(11) (then 11 U.S.C. section 861) of Chapter XII, a plan might be confirmed over the objection of particular classes of creditors, only if those classes were given "adequate protection."

Subsection (c) of section 461(11) provided that the adequate protection requirement would be met if the dissenting classes were paid the value of their debts in cash. The Pine Gate line of cases, interpreting this subsection, held that the value of the mortgage indebtedness where the debt is non-recourse (as has been normal in many commercial real estate mortgage transactions) is equal to the value of the collateral. Since reorganization

often occurs under depressed market conditions, the value of the collateral would often be less than the amount of the debt; for example, in In re KRQ Assoc., 4 Bankr. Ct. Dec. (CRR) 462 (Bankr. S.D.N.Y. 1978), where there were some $14 million in mortgages on the property, the court found the value of the property to be $895,000.

Under the Pine Gate line of cases, secured creditors willing to take the collateral in satisfaction of the debt were not permitted to do so. The plan would be confirmed, the debtor would keep the collateral free of the mortgages, and the secured creditors would be paid the then depressed value of the collateral, which might be significantly less than the debt. Due to the non-recourse nature

of the debt, the secured creditors would not have an unsecured claim for their loss.[2]

As a direct response to the inequity of the Pine Gate line of cases, when the Bankruptcy Code was being drafted, Congress was specifically asked to restore absolute priority to real estate arrangements and override Pine Gate.[3]

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[2] While in Ahlers below, the mortgagee has an unsecured claim, the decision renders that claim of little value. Thus the result under Pine Gate is similar to Ahlers. However, the mortgagee is hurt more under Ahlers than under Pine Gate because (i) rather than receiving cash equal to the value of the collateral as was required in Pine Gate, under Ahlers below the mortgagee will receive only a lien, the payments under which the court has determined have a present value equal to the value of the collateral, and (ii) Ahlers applies to both recourse and non-recourse debt, while the Pine Gate rule dealt only with non-recourse debt.

[3] See, e.g. Testimony of John J. Creedon on behalf of the American Council of Life Insurance, Hearings on S.2266 and H.R.8200 before the Subcommittee on Improvements in the Judicial Machinery of the Senate Committee on the Judiciary, 95th Cong., 1st Sess. 583, 584-85 and materials cited supra, note 1.

Congress responded. It enacted a series of complex provisions as part of the Bankruptcy Code designed to protect the undersecured creditor by overcoming the Pine Gate rule. These provisions included sections 506(a), 1111(b) and 1129(b)(2). Together they insure that the mortgagee may have both a secured claim for the value of the collateral and an unsecured claim for the difference between that value and the amount of the indebtedness. They provide absolute priority for each of these claims.

By effectively reading absolute priority for the unsecured claim out of section 1129, the opinion below undermines this Congressional package of mortgagee protection. Specifically, this package was designed to protect the mortgagee in the following manner:

1. 11 U.S.C. §506(a). Under section 506 (a), an allowed claim is a secured claim to the extent of the value of the collateral. The allowed claim of a secured creditor in excess of the value of the collateral is an allowed unsecured claim. Without more, this provision would not have provided the non-recourse mortgagee with an unsecured claim. Even if absolute priority were accorded the secured claim, the non-recourse mortgagee would, by virtue of section 506(a) alone, be left, as in Ahlers below, with a lien equal to the value of the collateral and no protection for the difference between that value and the amount of the debt.

2. 11 U.S.C. Section 1111(b). To prevent such a result, Congress added section 1111(b). It provides that a non-recourse claim will be allowed or disallowed as if it were a recourse

claim,[4] thereby insuring that every mortgagee would be entitled, on plan confirmation, to an unsecured claim for its unsatisfied balances.

3. 11 U.S.C. Section 1129(b). Next, section 1129(b)(1) requires that the plan be "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan". Thus, whether a mortgage is recourse, or has been converted to a recourse claim under section 1111(b), the mortgagee may have absolute priority for both its secured and unsecured claims.

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[4] Alternatively, secured creditors may elect under section 1111(b)(2) to have a secured claim for the full amount of the indebtedness without an unsecured claim. However, since deferred cash payments under the lien for the full secured claim may have a present value on cram-down as low as the value of the collateral (section 1129(b)(2)(A)), it is the recourse claim that protects the secured creditor against the Pine Gate rule.

Under section 1129(b)(2)(A), absolute priority with respect to a class of secured claims will require that if the lien is retained on the property,[5] it will have a face amount equal to the allowed amount of the secured claim, with a present value at least equal to the value of the collateral. As an example of the foregoing, a secured creditor with a mortgage of $15 million on property with a value at the time of bankruptcy of $10 million, would have a lien of $10 million, the payments under which would have a present value of $10 million.

The knot of protection for the mortgagee is tied with the absolute priority requirement with respect to the

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5 Alternatives to retaining the lien include sale of the property in a manner protective of the secured claim or other methods that would provide for the realization by the mortgagee of the "indubitable equivalent" of its interest (See discussion of In re Murel Holding Corp. in part II infra of this brief).

unsecured claim. Under section 1129(b)(2)(B) (the provision involved in this case) the dissenting impaired unsecured class must receive property of a value equal to the allowed amount of its claims before any one junior receives any property. In the example, a recourse mortgagee, or a nonrecourse mortgagee whose claim has been converted under §1111(b), would have to receive on its $15 million dollar debt, before the debtor would be allowed to keep any property, a lien worth $10 million dollars on its secured claim plus property worth $5 million dollars on the unsecured claim.

This does not mean that there will be property available to pay the unsecured claim in full. It does mean that the debtor will not be able to keep the property unless this is accomplished. This is the provision that countermands

Pine Gate and the decision below. If the debtor is permitted to keep the property without paying the unsecured claims, simply by promising to work in the future, the foundation stone of mortgagee protection will have been removed from the Bankruptcy Code, and the mortgagee will have been relegated to a situation even more harmful than the Pine Gate rule[6], clearly in contravention of the intention of Congress and the language of the Bankruptcy Code.

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[6] See note 2, supra.

II

## THE COURT BELOW MISCONSTRUED SECTIONS 362(d)(1) AND 361 of THE BANKRUPTCY CODE (11 U.S.C. SECTIONS 362(d)(1) AND 361)

A. Neither the language of the Bankruptcy Code nor the legislative history permits postponement of entitlement to adequate protection for a period estimated to equal the time it would have taken to foreclose free of redemption rights.

The court below held that adequate protection payments, where justified, should not begin to be paid until the lapse of a period equal to the time it would normally take to foreclose free of the debtor's right of redemption. This period might readily exceed the reorganization process. The holding reads a requirement into the Bankruptcy Code that contravenes the concept of

adequate protection, conflicts with the pertinent case law, and ignores Congressional intent.

Pursuant to section 362(a) of the Bankruptcy Code, the filing of a petition automatically stays all acts of creditors to enforce liens against the debtor's property. This was designed to give the debtor a "breathing spell" from creditors by halting collection efforts, harassment and foreclosure actions, and to protect creditors by providing "an orderly liquidation procedure under which all creditors are treated equally." H.R. Rep. No. 595, 95th Cong., 1st Sess. 340, reprinted in 1978 U.S. Code Cong. & Admin. News, 5963, 6297. To protect parties who have an interest in the debtor's property, such as secured creditors whose collateral may be declining in value, and who would be losing the time value of their interest,

Congress provided in 11 U.S.C. §362(d)(1) that the secured creditor could request and receive relief from the stay for cause, including the lack of adequate protection for its interest. Similarly 11 U.S.C. section 363(e) provides that "at any time" the court at the request of a person with an interest in the property, "shall" prohibit or condition the use, sale or lease of collateral as necessary to provide adequate protection for the interest of the creditor. It is significant that the Bankruptcy Code expressly provides for adequate protection "at any time" a request is made, and makes no provision for postponement of entitlement to such protection.

Three alternative means for providing adequate protection for a secured creditor -- cash payments, additional or replacement liens, or the "indubitable

equivalent" of what is lost are set forth in 11 U.S.C. §361. The phrase "indubitable equivalent" is derived from the language of Judge Learned Hand in In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935), which interpreted "adequate protection" in section 77B of the Bankruptcy Act of 1898. Section 77B mandated that secured creditors be given such protection in the event that a reorganization plan was confirmed over their objection.

Explaining the concept of adequate protection in the context of the rights of a secured creditor under a plan of reorganization, Judge Hand stated that

> [i]t is plain that 'adequate protection' must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to

> suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.

75 F.2d at 942 (emphasis added).

The use of the term "indubitable equivalent" in section 361 is important. It indicates the concern of the draftsmen that adequate protection actually compensate the secured party for the benefit of the bargain. Illusory protection or vague hopes would not do.

In commenting on section 361, the House Report states:

> Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.

H.R. Rep. No. 595, 95th Cong. 1st sess. 339, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6295.

In addition, these words incorporate the notion expressed by Judge Hand that payment in the future is not the same as payment now. This has special significance in light of the decision below that adequate protection payments, when required, may be postponed. It is also indicative of the reason the language in the House Bill's version of section 361 providing for adequate protection in the form of an administrative expense was deleted. See e.g. H.R. 8200, 95th Cong. 1st Sess. (1977) and H.R. Rep. No. 595, 95th Cong. 1st Sess. 340, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6296.

The principle of the decision below that adequate protection payments may be postponed for the period it would have

taken to foreclose and acquire possession permitting sale free of redemption rights, would be a virtual license to eliminate adequate protection for the mortgagee. In jurisdictions where judicial foreclosures are the norm, the time involved in serving the necessary parties, including tenants, and waiting for clogged court calendars can easily consume months and sometimes years as the following comment from a major treatise in the field indicates:

> In spite of being the most pervasive method of foreclosure in America today, it [judicial foreclosure] has serious disadvantages. It is complicated, costly, and time-consuming. A typical action in equity to foreclose and sell involves a long series of steps: a preliminary title search to determine all parties in interest; filing of the foreclosure bill of complaint and lis pendens notice; service of process; a hearing, usually by a master in chancery who then reports to the court; the decree or judgment; notice of sale; actual sale and issuance of certificate of sale; report of the sale; proceedings for

> determination of the right to any surplus; possible redemptions from foreclosure sale; and the entry of a decree for a deficiency.

G. Nelson and D. Whitman, Real Estate Finance Law 506 (2d ed. 1985) (footnotes omitted).

Even in states where mortgages or deeds of trust are foreclosed under power of sale, a process that takes considerably less time than judicial foreclosure, there is often a long redemption period provided by statute after the sale that, under the Ahlers opinion below, would extend the period of delay in the commencement of adequate protection. For example, in this case the redemption period was 12 months.[7]

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[7] Added to these periods of time is Ahlers' holding that the payments themselves must be scheduled at the time the debtor is expected to earn the income to pay them. If the entire property subject to the mortgage is leased to a tenant that pays rent semi-annually or to a tenant that has been granted free rent for two years as an inducement to sign a (footnote continued)

It would seem apparent that in many situations, if the decision below were upheld, adequate protection could be postponed for a period that would exceed the period of the bankruptcy proceedings, thus depriving the secured creditor of any of the benefits of adequate protection for its loss. Clearly it was not the intent of Congress that the protection it incorporated into the Bankruptcy Code could be so easily evaded.

Nothing in the language of the Bankruptcy Code or in the legislative history to its codification of the adequate protection concept would

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(footnote continued from previous page) long term lease in a poor market, it could be argued following Ahlers that payments should be required only at six month intervals, or postponed for two years. In that situation, if the tenant or the borrower defaults when the payments are due, the mortgagee will have received no adequate protection for the period in question.

indicate any intent to permit postponement of required adequate protection. The Eighth Circuit's decision then, if it is to have any validity, must be based on an argument that the mortgagee has no loss until a period equal to the estimated foreclosure and acquisition free of redemption rights has passed. That such an argument could not be sustained is next discussed.

B. The Eighth Circuit's postponement of adequate protection deprives the mortgagee of compensation for loss in value of the collateral and for lost opportunity costs.

There are two losses a mortgagee generally suffers during the period of the stay. The first is the loss occasioned by a reduction in the value of the real property serving as security for the mortgage. This may occur because of such things as declining real estate values, deferred maintenance and unpaid taxes. The second represents lost opportunity costs, the loss the mortgagee suffers by not being able to invest the value of the collateral. The first loss has been recognized as a basis for adequate protection, apparently by all courts. Among the circuits that have spoken, the second loss is recognized by the Ninth Circuit, In re American Mariner Indus., 734 F.2d 426 (9th Cir. 1984), and the Fourth Circuit, Grundy Nat'l Bank v.

Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); rejected by the Fifth Circuit, In re Timbers of Inwood Forest Assoc., Ltd., 793 F.2d 1380 (5th Cir. 1986) (opinion withdrawn, rehearing held September 22, 1986, opinion reinstated January 9, 1987) and recognized on a case-by-case basis by the Eighth Circuit, In re Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985).

With respect to the first loss (falling value), it is not in any way based upon or delimited by the date on which the mortgagee would be able to foreclose and acquire the property free of redemption rights. This is not a question of when the mortgagee may obtain the assets for investment. It is a question of what is happening to the value of the investment in the then current market. Judge Hand in Murel admonished that payment in the future was

not adequate protection for today's loss. What the Eighth Circuit has held is even more serious since payments would be made at the later date only for losses accruing thereafter. Indeed, the Eighth Circuit below held that the collateral should not even be valued for adequate protection purposes until the period of postponement has expired. In re Ahlers, 794 F.2d 388, 396 (8th Cir. 1986).

The Eighth Circuit ignores this loss in collateral value, notwithstanding that it acknowledged land values had "declined by at least twenty-four percent in the twelve month period immediately proceeding the filing of the Petition in Bankruptcy," 794 F.2d at 397, and "the evidence demonstrates that the collateral decreased in value after the adequate protection valuation," 794 F.2d at 398,[8]

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[8] Because of this reduction in value, the Eighth Circuit found the District (footnote continued)

and notwithstanding that the debtor's own calculation of value showed a reduction in the value of the collateral from the filing of the debtor's petition on November 30, 1984 to February 27, 1985 of $24,000. Pet. A-63, n. 5. The Eighth Circuit, by reinstating the stay, postponing entitlement to any adequate protection for one year and 60 days, and failing to protect the mortgagee from loss in value of collateral, has deprived the mortgagee of any adequate protection for the period of the stay. Since

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(footnote continued from previous page) Court in error in not ordering a new valuation to determine the feasibility of the plan. Apparently, the Court felt that the revaluation right render the plan feasible because the reduced value of the collateral would result in a reduction in the value of the mortgage under the plan and, therefore, in lower future debt service payments. The Eighth Circuit, however, did not consider that this acknowledged reduction in value of the collateral and the consequent reduction in the value of the mortgage required adequate protection during the period the value was dropping and the stay was in effect.

adequate protection payments would be made after the postponement only for losses accruing thereafter, the mortgagee would never receive payment for the loss in value of collateral suffered during this period.

It was only the second loss (lost opportunity costs) to which the Court directed its attention. Even with respect to this loss, it should be clear that the postponement results in inadequate protection for a period <u>in addition to</u> the time it would take to foreclose and obtain possession free of redemption rights. The Eighth Circuit ignores the fact that these periods do not disappear while the stay is in effect. If relief from the stay is eventually granted, the mortgagee will have to wait the same period of time for which the court delayed adequate protection payments in order to be in a

position to sell the property free and clear of redemption rights. Thus the Eighth Circuit's decision has the effect of permitting the court to extend the period it would take the mortgagee to realize a return from the collateral for up to double its actual time.

Furthermore, the mortgagee's ability to realize on the investment is not limited to the date of foreclosure free and clear of redemption rights. The mortgagee may dispose of the mortgage itself prior to that date. The Eighth Circuit ignores the fact that the amount the mortgagee can realize upon sale of the mortgage will be reduced because of the time it will take to obtain free and clear possession of the property, a delay that is being extended by the stay. Under the Ahlers decision, each day of

the stay creates a loss for the mortgagee that is uncompensated for the period of postponement.

According to the leading treatise in the field, "the most important message of the Code" for secured creditors is that "the value of their secured position as it existed at the commencement of the case is to be protected throughout the case." 2 Collier, Bankruptcy, section 361.01 (15th (L. King) ed. 1986). Yet this value is exactly what is not protected when entitlement to adequate protection payments is eliminated for significant periods of time. The court below, by postponing adequate protection, has destroyed the delicate balance between the stay and adequate protection built into the Bankruptcy Code, under which the assets of the debtor are shielded from creditors, and creditors are shielded from loss. In the case

below the Eighth Circuit has turned this shield into a debtor's sword and has deprived the secured creditor of the value of its secured position as it existed at the commencement of the case.

## CONCLUSION

The misinterpretation of the absolute priority and adequate protection provisions of the Bankruptcy Code by the Eighth Circuit below in Ahlers distorts the language of the statute and the intention of Congress. While the case involved a farming operation, the legal conclusions are applicable to all Chapter 11 cases. Cf. In re Star City Rebuilders, Inc. 62 B.R. 983 (Bankr. W.D. Va. 1986). Unreversed, the decision will have a severe impact on the real estate industry, tighten credit, increase litigation, further clog bankruptcy courts, and leave uncertain the meaning

of key provisions of a major statute affecting the economic health of the nation.

Literally billions of insurance policy holder, trust, and mortgagee dollars have been lent to borrowers on the strength of real property collateral and the changes made in the Bankruptcy Code. These changes in the Code were created to protect lenders whose rights were seriously jeopardized by the Pine Gate rule and to mandate priorities and adequate protection which were not clearly available in the predecessor Bankruptcy Act. The decision below not only threatens the existing mortgage debt that these lenders hold but, also threatens future mortgage lending needed within the real estate industry.

The American College of Real Estate Lawyers agrees with Judge Gibson's dissent from denial of rehearing en banc,

that "[t]his case... can now be resolved only in the Supreme Court. We are left to hope that, upon proper petition, it will grant certiorari." 794 F.2d at 416. We further hope that the erroneous result below will be reversed.

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**CERTIFICATE OF SERVICE**

Appropriate copies served by U.S. Mail upon all record counsel this 22d day of January, 1987 and on this date forty copies were sent to the Clerk, Supreme Court of the United States. An affidavit of service has been filed by a Member of the Bar of this Court.

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Attorney

# PETITIONER'S

# BRIEF

Supreme Court, U.S.
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No. 86-958

In The
# Supreme Court of the United States
October Term, 1987

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT**

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## QUESTION PRESENTED

1. Do the absolute priority provisions of Section 1129 of the Bankruptcy Code (11 U.S.C. § 1129) and this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), prohibit confirmation of a debtor's proposed reorganization plan where (i) the senior interests of unsecured creditors will not be paid in full; (ii) the debtor will retain ownership of property; and (iii) the debtor's only contribution to the plan of reorganization is the debtor's non-cash promise to provide future labor, experience and expertise?

## LIST OF PARTIES

The parties to the proceedings below were Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul, and Respondents James R. Ahlers and Mary M. Ahlers. In addition, the United States Trustee participated in the proceedings with respect to matters not involved in this certiorari proceeding.

Petitioner Norwest Bank Worthington is a subsidiary of Norwest Corporation. Pursuant to Supreme Court Rule 28.1, there is included in the Appendix (Pet. App. A101) a listing of Norwest Corporation and its corporate affiliates.

Petitioner Federal Land Bank of St. Paul is a federal instrumentality chartered by the Farm Credit Administration under 12 U.S.C. § 2011. It is a part of Farm Credit System established pursuant to the Farm Credit Act, 12 U.S.C. § 2001 *et seq.* Pursuant to Supreme Court Rule 28.1, there is included in the Appendix (Pet. App. A107) a statement describing Farm Credit System and its primary affiliates.



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## OPINIONS BELOW

The July 2, 1986, opinion of the Court of Appeals for the Eighth Circuit is reported at 794 F.2d 388 and is reprinted in the Appendix (Pet. App. A1).

The September 17, 1986, Order of the Court of Appeals denying Petition for Rehearing En Banc has been reported at 794 F.2d 414 and is reprinted in the Appendix (Pet. App. A51). The October 16, 1986, Order of the Court of Appeals on Motion for Clarification of Order Denying Petition for Rehearing En Banc has not been reported and is reprinted in the Appendix (Pet. App. A57).

The October 22, 1985, Order of the United States District Court for the District of Minnesota (Alsop, C.J.) has not been reported and is reprinted in the Appendix (Pet. App. A79).

The March 15, 1985, Order of the United States Bankruptcy Court, District of Minnesota (O'Brien, J.) has not been reported and is reprinted in the Appendix (Pet. App. A59).

## JURISDICTION

Federal jurisdiction over bankruptcy proceedings below under Title 11, United States Code, arises under 28 U.S.C. § 1334 and § 157. On July 2, 1986, the Court of Appeals for the Eighth Circuit reversed the lower courts' orders granting Petitioners' motion for relief from the automatic stay of 11 U.S.C. § 362. The Petition for a

writ of certiorari was filed on December 9, 1986, and was granted on June 22, 1987. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

## STATUTES INVOLVED

This case involves consideration of the absolute priority provisions under Section 1129 of the Bankruptcy Code, 11 U.S.C. § 1129, in connection with confirmation of a bankruptcy debtor's plan of reorganization. Pursuant to Supreme Court Rule 21.1(f), the text of this section is set forth in the Appendix (Pet. App. A95-99).

## STATEMENT OF THE CASE

The issue presented in this certiorari proceeding involves the effort of a divided panel of the United States Court of Appeals for the Eighth Circuit to interpret the absolute priority provisions of the Bankruptcy Code to permit a debtor to retain property under a plan of reorganization over the objections of unpaid senior creditors. The factual and procedural background material to consideration of the issue presented is described below.

Respondents James and Mary Ahlers are grain and livestock farmers who farm approximately 840 acres of



land in Nobles County, Minnesota. To finance their operations, they borrowed money from Petitioner Federal Land Bank of St. Paul ("Federal Land Bank"); these loans, in the aggregate principal amount of $525,854, as of November 30, 1984, were secured by first mortgages on four separate parcels of real estate.

Respondents also borrowed money from Petitioner Norwest Bank Worthington ("Norwest"). To secure those loans, Respondents gave Norwest a second mortgage on the real estate and a security interest in machinery, equipment, crops, livestock, and other collateral. As of November 30, 1984, Respondents owed Norwest $450,468 in principal and accrued interest.

Following Respondents' default in payment obligations to Norwest, on November 16, 1984, Norwest commenced a replevin action in Minnesota state court to recover possession of its equipment and machinery collateral. Fourteen days later, Respondents filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, thereby staying the state court replevin proceedings by reason of 11 U.S.C. § 362(a). Norwest and Federal Land Bank each filed motions for relief from the automatic stay and, on February 27, 1985, the Bankruptcy Court held an evidentiary hearing on these motions.

At the evidentiary hearing, Federal Land Bank and Norwest presented expert testimony regarding valuation of the real estate securing the first mortgages to Federal Land Bank and the second mortgage to Norwest. Norwest also presented evidence respecting valuation of its personal property collateral. Respondent James Ahlers' testimony

presented his opinions of the value of the real estate and other collateral.

The Bankruptcy Court accepted Petitioners' expert testimony as to valuation of the real estate, and concluded that Federal Land Bank was substantially undersecured as to certain of the real estate, and that it was entitled to relief from the automatic stay unless Respondents could provide adequate protection of Federal Land Bank's interest in the property.[1]

With respect to Norwest's position, the Bankruptcy Court similarly accepted Norwest's evidence respecting valuation of its collateral, and concluded that, although Norwest had been fully secured as of the date of filing the petition in bankruptcy, its position had eroded due to accrual of interest on certain of Federal Land Bank's senior mortgages and due to erosion of Norwest's collateral values. Finding Norwest to have become undersecured, the Bankruptcy Court held that Norwest also was entitled to relief from the automatic stay unless Respondents could provide adequate protection of Norwest's interests in its collateral.

By its order of March 15, 1985 (Pet. App. A59), the Bankruptcy Court found Respondents' offers of adequate protection were insufficient to protect the secured interests of Federal Land Bank and Norwest, and that adequate protection would require payments equal to interest at 12 percent on the values of the undersecured collateral. Since Respondents were unable to provide adequate protection, the Bankruptcy Court granted the motions of Federal Land Bank and Norwest to lift the automatic stay to permit them to proceed against their collateral.

1. In general, "adequate protection" is the payment or other protection which a debtor in bankruptcy must provide to a secured creditor in order to be able to continue to use that secured creditor's collateral. *See* 11 U.S.C. §§ 361, 362(d), and 363. Adequate protection to a secured creditor may take the form of periodic payments, replacement liens, or other forms of protection sufficient to provide the "indubitable equivalent" of the creditor's interest in the property, 11 U.S.C. § 361(3). Issues relating to the nature and scope of the creditors' interests for which adequate protection must be provided are before this Court in *In re Timbers of Inwood Forest Associates, Ltd.*, No. 86-1602, *cert. granted* May 26, 1987.



Respondents' post-hearing motions and motions for stay pending appeal were denied by the Bankruptcy Court and by the District Court. Respondents appealed the Bankruptcy's Court's orders to the United States District Court and also appealed from the Bankruptcy Court's July 8, 1985, Order granting Norwest's motion for recovery of its collateral.

After Respondents' efforts to stay both the replevin order and the order lifting the stay had been denied by the District Court, Respondents sought stays pending appeal from the United States Court of Appeals for the Eighth Circuit. By order of August 8, 1985 (Pet. App. A75), the Court of Appeals stayed enforcement of the lower court orders. In doing so, the Court of Appeals also requested that the District Court determine the merits of the matter, including the feasibility of Respondents' reorganization in bankruptcy (Pet. App. A77).

By order entered October 22, 1985 (Pet. App. A3), the District Court (Alsop, C.J.) affirmed the lift-stay orders of the Bankruptcy Court, and reviewed the feasibility of reorganization. Applying the feasibility factors set forth in *United Properties, Inc. v. Emporium Department Stores, Inc.*, 379 F.2d 55, 66-71 (8th Cir. 1967), the District Court found that:

> Analysis of debtors' proposed plan in light of these considerations reveals the plan's utter unfeasibility. The court presumes the debtors are capable farmers and managers, despite their present difficulties. All their other circumstances, however, militate strongly against success.

Order, October 22, 1985 (Pet. App. A86).

In reaching that decision, the District Court found that the Respondents had a negative asset to liability ratio, were insolvent by a large margin, and further observed:

> Debtors also have failed to establish their ability to operate profitably in the future. Indeed, debtors have suffered large losses in recent years. Tr. 139. Debtors have no significant cash flow. Tr. 144. Finally, the oppressive economic conditions confronting American farmers are unlikely to improve soon, and any political assistance will be too little and too late to redeem circumstances as dire as debtors'. Therefore, debtors stand little chance of reorganizing successfully, even without regard to the monthly adequate protection payments required under Section 361.

*Id.* (Pet. App. A87).

On Respondents' appeal to the Eighth Circuit, the parties addressed issues which had been presented to the lower courts, and which were raised by Respondents in their appellate brief, including the sufficiency of Respondents' offers of adequate protection (Appellants' Brief, pp. 33-38), the applicability of the "lost opportunity cost" component of adequate protection as expressed in *In re American Mariner*, 734 F.2d 426 (9th Cir. 1984) (Appellants' Brief, pp. 20-26), and the bases for lifting the automatic stay, including lack of feasibility of reorganization under the factors expressed in *United Properties* (Appellants' Brief, pp. 26-33).



In their briefs to the Court of Appeals, Federal Land Bank and Norwest responded to the contentions raised by the appellants, including, among other things, the applicability of *American Mariner* and the lack of feasibility of reorganization. On the question of feasibility, Norwest pointed out that, in addition to failing to meet the *United Properties* analysis employed by the District Court, Respondents' reorganization also could not be feasible because the "absolute priority" requirements of 11 U.S.C. §§ 1129(a)(8) and 1129(b) would make a proposed plan of reorganization unconfirmable over the objection of impaired unsecured creditors. (Brief of Appellee Norwest, pp. 22-23).[2]

In their reply brief to the Court of Appeals, Respondents attacked the refusal of the Bankruptcy Court to accept liens on future crops as adequate protection (Appel-

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2. 11 U.S.C. § 1129 provides generally that in order to confirm a plan of reorganization over the objection of an impaired class of claims, the plan must be "fair and equitable," and "... the condition that a plan be fair and equitable with respect to a class includes the following requirements:

• • •

> (B) With respect to a class of unsecured claims—(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. § 1129(b)(2)(B).

lants' Reply Brief, pp. 16-19), continued their attack on the applicability of *American Mariner* (*Id.* pp. 3-4), and attacked the District Court's analysis of feasibility under *United Properties* (*Id.* p. 11). Significantly, at no time did Respondents challenge the applicability of the absolute priority rule of 11 U.S.C. § 1129(b), nor did Respondents suggest that the absolute priority rule could be overcome by a debtor's promise of future labor, experience, and expertise.

The appeals were argued before a three-judge panel of the Court of Appeals on January 13, 1986. In a decision entered July 1, 1986 (the "Panel Decision") (Pet. App. A1), the panel reversed Chief Judge Alsop's decision affirming the Bankruptcy Court's lift-stay orders and the finding that the Respondents' plan of reorganization was not feasible. The majority opinion was written by Judge Heaney, and was joined by Judge Wolfman, with Judge Gibson dissenting. The majority opinion concluded that the automatic stay should not have been lifted to permit Federal Land Bank and Norwest to foreclose, and that the lower courts' determinations that reorganization was not feasible were in error. These conclusions were reached by the following reasoning:

1. Respondents had no obligation to provide adequate protection to preserve the automatic stay until such time as Federal Land Bank and Norwest, under state law, would otherwise have been able to seize their collateral, sell the property, and reinvest the proceeds. In the case of real estate, the Panel Decision thus held that the obligation to provide adequate protection would not begin for one year and six weeks (Pet. App. A12).



2. In determining the value of the creditors' interests to be protected once the obligation to provide adequate protection comes into being, the court must determine the value of the interest in collateral as of the time the obligation arises; that is, the value to be protected in real estate is the value existing after expiration of the notice and redemption periods (Pet. App. A13).

3. Once the obligation to provide adequate protection does arise, no actual payments need be made until the debtor's cyclical business has cash available; *e.g.*, after crops or livestock have been sold (Pet. App. A14).

4. Because there would be no current obligation to provide adequate protection for the real estate, cash which otherwise would have been paid as adequate protection would be available to the debtors and thus would support the feasibility of reorganization. Moreover, the plan would be feasible and confirmable over the objections of impaired unsecured creditors and, notwithstanding the absolute priority rule, the debtors would be able to retain their business without payment in full to the dissenting class of creditors because the debtors' future services, management, and expertise in operating their farm would be the equivalent of a capital contribution, thus avoiding application of the absolute priority rule (Pet. App. A2-3, 24-25).

5. Finally, to demonstrate how a reorganization might in fact be accomplished under the announced criteria, the Panel Decision undertook a projected analysis of the debtors' operations based upon data outside the record, chiefly

published values of land, equipment, and production costs and reported commodities prices (Pet. App. A37-49). From this analysis the Court devised its own suggested plan of reorganization that would permit the debtors to retain ownership of their operation (Pet. App. A37-49).

The dissenting opinion disagreed with the adequate protection analysis of the majority opinion, and criticized the majority opinion for failing to observe the clearly erroneous standard for review of the lower courts' findings as to adequate protection and feasibility of reorganization (Pet. App. A28-36). The dissent also criticized the majority's holding that a debtor's "experience, knowledge, and labor" is the equivalent of capital sufficient to avoid the rule of absolute priority in bankruptcy, viewing the holding as unsupported by *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

Petitioners sought rehearing, with a suggestion for rehearing *en banc*. On September 17, 1986, on a vote of five in favor of rehearing, four opposing rehearing, and one not voting, the Court of Appeals denied rehearing (Pet. App. A51). Even though a majority of the judges voting favored rehearing *en banc*, rehearing was denied under 28 U.S.C. § 46(c) because an absolute majority (i.e., six) of the ten active circuit judges had not voted to grant rehearing. The five judges favoring rehearing filed dissenting opinions (Pet. App. A53-55). In the dissenting opinion on behalf of four of the judges, Judge Gibson stated that "the court has altered the relationship between debtor and creditor, invading serious policy issues properly the concern of Congress, and in doing so has substituted its own findings of fact for those made by the bankruptcy and district courts." (Pet. App. A54-55).



The Court of Appeals denied a motion to vacate the order denying rehearing, but granted a stay of the mandate to allow time for filing a petition for certiorari (Pet. App. A58). The petition for a writ of certiorari was timely filed, and was granted on June 22, 1987, as to the absolute priority issue.

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## SUMMARY OF ARGUMENT

In this case, in an apparent effort to assist beleaguered farmers through a reorganization under Chapter 11 of the Bankruptcy Code, a divided panel of the Court of Appeals disregarded both the plain language of the statute and long-standing precedent of this Court.

The absolute priority rule of 11 U.S.C. § 1129 mandates that a shareholder or a business owner may not retain any property in a reorganization over the objection of senior creditors without first satisfying the claims of such creditors in full. The court below nonetheless held that a debtor may retain ownership in a reorganized enterprise by contributing his promise of labor and experience, instead of capital, in a reorganization plan that does not fully repay creditors with superior interests.

That holding is impermissible in light of the plain language of the Bankruptcy Code. Although Congress had been presented with proposals to make exceptions to the rule of absolute priority to allow retention of property in exchange for contributions of management skill and other non-cash contributions, the Bankruptcy Code, as enacted by Congress, contains no such exception. While pre-Code case law did allow the possibility of such

retention in exchange for an infusion of fresh capital in reorganization, this Court rejected the notion that shareholders' future contributions of management skills could permit them to participate in ownership of the reorganized business. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 122-23 (1939). The decision below is thus not only contrary to the express language of the Bankruptcy Code, it is also directly contrary to the prior precedent of this Court and must be reversed.

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## ARGUMENT

### THE COURT BELOW VIOLATED ESTABLISHED LEGAL PRINCIPLES OF ABSOLUTE PRIORITY UNDER 11 U.S.C. § 1129(b)(2)(B) AND THE DECISION OF THIS COURT IN CASE V. LOS ANGELES LUMBER PRODUCTS CO., 308 U.S. 106 (1939), BY HOLDING THAT A BANKRUPTCY DEBTOR, BY A MERE PROMISE OF FUTURE LABOR, EXPERIENCE AND EXPERTISE, MAY RETAIN OWNERSHIP OF THE REORGANIZED ENTERPRISE WITHOUT PAYING DISSENTING CREDITORS IN FULL.

#### A. Procedural and Statutory Framework.

As noted in the dissenting opinion below (Pet. App. A54), the panel decision in *Ahlers* has altered the relationship between debtor and creditor. The Bankruptcy Code reflects a careful congressional balancing of the rights and interests of the debtor and various classes of creditors. The goal of that congressional balancing is to promote both reorganization and fair treatment of creditors through a process of informed negotiations, a process whereby both creditor and debtor can rely on the statutory language of the Bankruptcy Code and be cognizant of their respective rights and obligations.



The Bankruptcy Code further requires full factual disclosure in connection with confirmation of a plan of reorganization. Confirmation of a plan of reorganization under Chapter 11 of the Bankruptcy Code requires a written disclosure statement, approved by the bankruptcy court, adequately informing all creditors about the debtor's operations and the proposed plan of reorganization. 11 U.S.C. § 1125. Creditors are asked to vote on the proposed plan prior to the confirmation hearing. 11 U.S.C. § 1126; Bankruptcy Rule 3018. Confirmation of the plan occurs after a hearing and approval by the bankruptcy court. 11 U.S.C. §§ 1128, 1129.

Section 1129(a) sets forth the requirements for confirmation of a plan. Among those requirements is acceptance by each class of claims or interests that are impaired under the plan. 11 U.S.C. § 1129(a)(8). A claim or interest is impaired unless the plan does not alter the rights of the holder of the claim or interest. 11 U.S.C. § 1124. Nonetheless, a plan can be confirmed without acceptance by all classes if the "cram down" provisions of Section 1129(b) are satisfied. To confirm such a plan, the bankruptcy court must find that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1).

The phrase "fair and equitable" developed as a term of art in bankruptcy. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 115 (1939). After years of judicial development, Congress provided a partial definition in Section 1129(b)(2). The essence of the "fair and equitable" requirement is that all creditors and interest holders receive at least as much as they would if the debtor were immediately liquidated: secured creditors must receive the value of their collateral, unsecured creditors

share the unencumbered assets and equity, and shareholders or other equity interest holders receive whatever remains, according to their relative priorities. This concept of relative priorities also requires that, to be fair and equitable, a plan of reorganization must first satisfy the claims accorded higher priority before any distribution to lower-priority classes. As will be seen, under the "Absolute Priority Rule," a debtor or shareholder may not retain any property under a plan of reorganization over the objection of creditors whose allowed claims are not paid in full.

### B. Judicial Development of the Absolute Priority Rule

The Absolute Priority Rule was first established in *Louisville Trust Company v. Louisville, New Albany and Chicago Railway Company*, 174 U.S. 675 (1898), when the Court held that the rights of shareholders are subordinate to the rights of both secured and unsecured creditors in bankruptcy. The Court further stated that any arrangement by which the rights of shareholders are "secured at the expense of the prior rights of either class of creditors comes within judicial denunciation." *Id.* at 684. The rule was reaffirmed in *Northern Pacific Railway Company v. Boyd*, 228 U.S. 482 (1912), and *Kansas City Terminal Railway Company v. Central Union Trust Company*, 271 U.S. 445 (1925). Simply put, the Absolute Priority Rule prohibits confirmation of a plan of reorganization over the objection of creditors if shareholders, or other equity interest holders, receive an interest in the reorganized debtor on account of their prior interest, when unsecured creditors are not paid in full.

In *Los Angeles Lumber*, the Court continued to uphold the Absolute Priority Rule and, while noting that shareholders are not prohibited from participating in the reorganized debtor if they contribute new capital, specifically rejected proffered management skills and "financial standing and influence in the community" as consideration for retention of equitable interests. 308 U.S. at 122. According to the Court:



> [T]hey [management skills, financial standing and influence in the community] cannot possibly be translated into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the assets column of the balance sheet of the new company. They reflect merely vague hopes or possibilities. As such they cannot be the basis for issuance of stock to otherwise valueless interests. The rigorous standards of the absolute or full priority doctrine of the Boyd Case will not permit valueless junior interests to perpetuate their position in an enterprise on such ephemeral grounds.

*Id.* at 122-23. Under the judicially developed Absolute Priority Rule, shareholders or equity interest holders may receive an interest in the reorganized debtor only if new capital is essential to the success of reorganization and the old shareholders or equity interest holders "make a fresh contribution and receive in return a participation reasonably equivalent to their contribution. . . ." *Id.* at 121. The *Los Angeles Lumber* holding was repeatedly and strongly affirmed in *Consolidated Rock Products v. De Bois*, 312 U.S. 501 (1940), *Marine Harbor Properties v. Manufacturers Trust Company*, 317 U.S. 78 (1942), *Securities & Exchange Commission v. American Trailer Rentals Company*, 379 U.S. 594 (1965), and *United States v. Key*, 397 U.S. 322 (1970). Until *Ahlers*, this concept was never questioned by the Court of Appeals. *See, e.g., Sophian v. Congress Realty Company*, 98 F.2d 499 (8th Cir. 1938); *Tellier v. Franks Laundry Company*, 101 F.2d 561 (8th Cir.

1939); *Metropolitan Holding Company v. Weadcock*, 113 F.2d 207 (6th Cir. 1940); *Spitzer v. Stichman*, 278 F.2d 402 (2d Cir. 1960); *In re Muskegon Motor Specialties*, 366 F.2d 522 (6th Cir. 1966); *In re Moulded Products, Inc.*, 474 F.2d 220 (8th Cir. 1973).

### C. Legislative Development

In 1970, Congress created the Commission on the Bankruptcy Laws of the United States (the "Bankruptcy Commission") and began a process which culminated in the adoption of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, our present Bankruptcy Code. Interestingly, one of the Bankruptcy Commission's proposals to Congress was to modify the Absolute Priority Rule and reject *Los Angeles Lumber*. *See Report of the Commission on the Bankrupty Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. 254-259 (1973). The Bankruptcy Commission endorsed participation in the reorganized debtor by former shareholders or equity interest holders in exchange for their management skill and labor. *Id.* at 258-59. After extensive hearings and debate,[3] the proposed

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3. Addressing the Bankruptcy Commission's proposal to allow equity interest holders to retain an interest when more senior creditors are not paid in full, Professor Vernon Countryman stated:

> [T]his proposal is merely a new stock watering device since it is still true, as the Court said in [*Los Angeles Lumber*] that the "important contribution" to be made by old management which managed the debtor into financial difficulty, "cannot possibly be translated into money's worth reasonably equivalent to the participation accorded to the old stockholders" and "has no place in the asset column of the balance sheet of the new company."

(Continued on following page)



modification was rejected by Congress and the Absolute Priority Rule was codified at Section 1129(b)(2). The legislative history makes it clear that to confirm a plan over the dissent of a class of unsecured claims, "they must be paid in full or, if paid less than in full, then no class junior may receive anything under the plan. This codifies the absolute priority rule from the dissenting class on down." H.R. Rep. No. 495, 95th Cong., 1st Sess. 413 (1977); *see also* S. Rep. No. 898, 95th Cong., 1st Sess. 128 (1977). The Rule leaves with the creditors—and not the debtor—the economic decision whether a plan should be confirmed if the debtor proposes to retain an interest in property and not pay all creditors in full.

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*Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 2d Sess. 12 (1975) (statement of Professor Vernon Countryman, *quoting Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 122-23 (1939)). Phillip A. Loomis, Jr., testifying for the Securities and Exchange Commission, noted that public stockholders would not be in a position to contribute management expertise and the proposed modification of the Absolute Priority Rule would favor management shareholders:

> We do not believe that Congress should provide a reward for the very persons under whose stewardship the corporation found its way into reorganization, while at the same time denying any participation by public stockholders. If management shareholders are important they can be paid more for their future efforts. They need not be compensated extra for their equity interest.

*Id.* 94th Cong., 1st Sess. 710 (1975). (statement of Phillip A. Loomis, Jr., Commissioner of the Securities and Exchange Commission). *See also Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 2d Sess. (1975).

### D. The Clear Language of 11 U.S.C. § 1129(b)(2)(B) Prohibits the Holder of an Interest Junior to the Class of Unsecured Claims From Receiving Any Property Under A Plan Unless The Unsecured Claims Are Paid In Full Or The Holders Of Those Claims Accept The Plan.

Neither the plan of reorganization proposed by the Respondents nor the plan drafted by the Court of Appeals provided for full payment of the claims of unsecured creditors. Nonetheless, under the Court of Appeals' plan, the Respondents would retain their ownership interest in the farming operation. Because this equity interest is junior to the class of unsecured claims, Section 1129(b)(2)(B) is not satisfied and the plan cannot be confirmed without the approval of the class of unsecured claims. Both Norwest and Federal Land Bank consistently informed the Respondents and the courts that they would not approve such a plan. Since these two creditors hold more than two-thirds of the total amount of the unsecured claims in this case, it is not possible to gain acceptance of the plan. *See* 11 U.S.C. § 1126(c).

Without such acceptance the plan cannot be confirmed. The language of 1129(b)(2)(B) is clear. To approve a plan as fair and equitable over the dissent of creditors, the court must find that shareholders or equity interest holders will not receive any property under the plan, unless the unsecured creditors are paid in full. The Court of Appeals recognized this fact and, in order to avoid the result required by Section 1129(b)(2)(B), fashioned an exception to the Absolute Priority Rule for junior interest holders who agree to contribute labor and management skill to the reorganization. However, this exception is found nowhere in the Bankruptcy Code. To the contrary, although the



Bankruptcy Commission specifically proposed a change in the Absolute Priority Rule to recognize contributions of labor and management skill, the proposal was not adopted by Congress and the Absolute Priority Rule as enacted by Congress in Section 1129(b)(2) admits of no exception; unless the equity interest holder can gain the consent of senior creditors to a plan of reorganization, the holder of such equity interest can retain property under the plan only if the claims of unsecured creditors are satisfied *in full*.

The intent of Congress cannot be more clearly manifested than it has been on the subject of the Absolute Priority Rule. Congress specifically rejected the exact modification which the Court of Appeals here adopted. While courts may disagree with the wisdom of Congressional action, they are bound to enforce it. The holding of the Court of Appeals allowing Respondents to retain their ownership interest and to confirm a plan of reorganization over the dissent of the class of unsecured claims must be reversed.

### E. Even if the Absolute Priority Rule Were to Permit A Shareholder Or Equity Interest Holder to Participate in Reorganization Over the Objection of Unpaid Unsecured Creditors, A Promise To Contribute Future Labor, Experience, And Expertise Does Not Provide A Sufficient Basis For Such Participation.

The Court of Appeals relied on *Los Angeles Lumber* to support its conclusion that a class junior to the dissenting unsecured creditors could retain property under a plan of reorganization in exchange for a promise to con-

tribute future labor, experience and expertise. That reliance was misplaced.

*Los Angeles Lumber* and its progeny are sometimes erroneously characterized as establishing an exception to the Absolute Priority Rule. Far from being a modification of the Rule, however, these cases simply recognize that, under pre-Code law, the shareholders or equity interest holders were not excluded from participation in the reorganization solely on account of their previous relationship with the debtor. Courts recognized the reality that, while new capital may be sought from any legitimate source, the former interest holders are more likely than others to be willing to contribute fresh capital. The judicially developed Absolute Priority Rule did not prohibit such participation so long as the property received by the interest holders was commensurate with their new capital contribution and not on account of their previous interest. *See Los Angeles Lumber*, 308 U.S. at 121-22.

The judicially developed Absolute Priority Rule was codified in Section 1129(b)(2). The legislative history does not suggest that Congress intended to incorporate the gloss of *Los Angeles Lumber* into the language of Section 1129(b)(2). The framework established by Congress could have provided for the purchase of an interest in the reorganized debtor by former shareholders or equity interest holders, but it does not. Instead, Congress created a system under which the creditors, and not the debtor or the courts, determine whether a plan which does not provide for full payment of all claims may be approved when it allows former shareholders or equity interest holders to obtain an interest in the reorganized debtor.



Even if *Los Angeles Lumber* survived the adoption of the Bankruptcy Code in 1978, nowhere in the Bankruptcy Code or the case law is there any support for the proposition that a former shareholder or equity interest holder can acquire an interest in the reorganized debtor by anything other than a contribution of capital. In *Los Angeles Lumber* the court rejected "financial standing and influence in the community" and "continuity of management" as a fresh contribution in exchange for new stock. 308 U.S. at 122. While the opinion does speak of "a contribution in money or in money's worth," the context makes it clear that the court is referring to cash substitutes; for example, a government security which the debtor might either sell or use as collateral to fund its operation. Thus, to the extent *Los Angeles Lumber* remains viable, it does not support the decision of the Court of Appeals in this case.

Under *Los Angeles Lumber*, capital was required because it is fundamentally different from other contributions, such as labor and management skill. Capital is committed at the outset, rather than during the course of reorganization. If the reorganization is unsuccessful, the new capital is available for distribution to creditors, whereas future labor and management skills are of no value when reorganization fails. To allow promises of labor and management skill to be substituted for a contribution of capital would shift the risk of further losses to the creditors, rather than the shareholders or equity interest holders who are supposed to bear the risks of economic enterprise. Moreover, labor or expertise is not a medium of exchange in our economy, and a promise of future labor and expertise provides no present value to

the enterprise, and no basis for recovery to creditors in the event the future labor and expertise are not provided or are not successful in maintaining the enterprise.

It should be noted that, to the extent the Absolute Priority Rule poses a significant obstacle to the reorganization of farmers and other individual debtors, Congress has enacted Chapter 12 and Chapter 13 of the Bankruptcy Code. Neither of these chapters, which are specifically limited to farmers and individuals, include the Absolute Priority Rule. *See* 11 U.S.C. §§ 1201-31, 1301-30.

It also should be noted that, notwithstanding the Absolute Priority Rule, and even without the attempted assistance provided by the *Ahlers'* Court's decision, it is quite possible to confirm a plan of reorganization under Chapter 11 even though the unsecured claims are not paid in full and the shareholders or other equity interest holders retain property under the plan. All that is required is consent from the classes of claims that are not paid in full. If the creditors are convinced that they will fare better under a plan involving the labor or management skill of an equity interest holder than they would in a liquidation, the creditors will approve a plan that provides property to that equity interest holder; if the creditors lack confidence in the offered labor and management skill, they will not consent to such a plan. The debtor may not unilaterally determine that such a contribution is necessary or valuable and thereby cram down a plan. By adopting the Absolute Priority Rule and rejecting the Bankruptcy Commission's proposed modification, Congress has placed the valuation of the equity interest holder's contribution in the hands of the creditors.



The Absolute Priority Rule recognizes the fundamental difference between debt and equity. It is a premise of our economic system that risk should be borne primarily by the equity interest holders, rather than creditors. Creditors in bankruptcy should not be required to bear an additional risk of loss, particularly when the equity interest holders are unwilling or unable to contribute new capital; rather, absent their consent, the creditors must be paid in full to the extent of the assets of the debtor. Continued operations under the management of equity interest holders who managed the debtor into bankruptcy may result in further diminution of the value of the estate and greater loss to the creditors. Assets otherwise available to satisfy the claims of unsecured creditors should not be depleted further in a futile reorganization which attempts to provide some return to the equity interest holders. The Absolute Priority Rule recognizes that creditors should have the ability to prevent equity interest holders from appropriating property at the expense of creditors and prevents well-informed shareholders or equity interest holders from taking advantage of the unsecured creditors. *See* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations,* 87 Harv. L. Rev. 1786, 1792 (1974).

## CONCLUSION

The holding of the Court of Appeals upsets the balance between creditors and equity interest holders created by the Absolute Priority Rule and specifically adopted

by Congress. The notion that a promise of future management and labor should permit equity interest holders to retain property over the objection of unpaid creditors was proposed to Congress and rejected. In ignoring the clear language of the Bankruptcy Code and, to the extent applicable, the prior precedent of this Court, the Court of Appeals has improperly shifted risk from equity interest holders to creditors; its decision must be revesed.

Dated: August 21, 1987

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# RESPONDENT'S

# BRIEF

Supreme Court, U.S.
FILED
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CLERK

No. 86-958

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1987

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NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS, and
MARY M. AHLERS,
*Respondents.*

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On Writ Of Certiorari
To The United States Court Of Appeals
For The Eighth Circuit

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## BRIEF FOR RESPONDENTS

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## QUESTION PRESENTED

Do the absolute priority provisions of Section 1129 of the Bankruptcy Code (11 U.S.C., Sec. 1129) and this Court's decision in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), prohibit confirmation of a debtor's proposed reorganization plan where (i) the senior interests of the unsecured creditors will not be paid in full; (ii) the debtor will retain ownership of the property; and (iii) the debtor's only contribution to the plan of reorganization is the debtor's non-cash promise to provide future labor, experience and expertise? (Brief for Petitioners, p. i)

Note: The Solicitor of the United States has submitted an Amicus Curiae Brief in which he discards the question presented for review by Petitioners to this Court, for the reason that he desires to present an entirely frivolous argument that this Court's decision in *Los Angeles Lumber* was not automatically embodied into section 1129 when Congress passed the Bankruptcy Code of 1978. As revealed by the issue above, Petitioners' contention is that Section 1129 *and* this Court's decision in *Los Angeles Lumber* would have to act in concert to prohibit confirmation of the plan of reorganization proposed by the Eighth Circuit for the debtors. The question of whether 11 U.S.C., Sec. 1129 now excludes all contributions to the plan was not raised below. Indeed, Judge Gibson's sole basis for dissent regarding the absolute priority rule was that contributions of future labor, experience and expertise were not of a capital nature as required by *Los Angeles Lumber*. This argument of the Solicitor General, as adopted by Petitioners cannot be raised now. The issue allowed by this Court is the one stated above.

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## STATEMENT OF THE CASE

Both the Petitioners and the Solicitor General have supplied what appears to be accurate statements of the facts involved in this case with regard to the absolute priority rule issue, and Respondents adopt them with the following reservations. Respondents object to Petitioners' attempts to relitigate the question of adequate protection which is not before this Court. Also, Respondents note that the absolute priority issue was thoroughly argued in the Court of Appeals during oral argument and was also raised in the Bankruptcy Court. Moreover, Petitioners' Statement is incomplete in that it fails to recite the safeguards imposed by the Court of Appeals:

In addition to requiring the Ahlers to contribute their services, management and expertise to their Plan, the Eighth Circuit also held that during the life of the plan, any excess profits (cash flow) unanticipated by the Plan would have to be made available to the unsecured creditors in pro rata payments until they were paid in full without interest. Also, during the life of the Plan, any amounts realized from the sale of land not used to satisfy the secured creditors would have to be shared with the unsecured creditors on the basis of Debtors' total contribution as it bears to unsecured creditors' claims at the time of sale until unsecured creditors are paid in full. According to the Court of Appeals, this would prevent an unfair offset or dilution of Ahlers' contributions for the retention of its proprietorship interest.

## SUMMARY OF ARGUMENT

The Court of Appeals has not violated established legal principles by holding that a contribution of future labor and skill can serve to implement a plan of reorganization. Rather, the Court of Appeals decision allows the retention

of a worthless proprietorship interest by debtor in order to forward the interests of all creditors and the estate.

An owner's contribution of labor and skill to the reorganized business is new value of measurable money's worth and constitutes a new investment.

Chapter 11, the reorganization provision of the Bankruptcy Code, is presently the only effective method for distressed small business, including farmers, to fairly deal with their creditors.

The present farm financial crisis is the fault of the government, lenders and agri-business leaders who have the capacity and means to forecast sound economic conduct; they have a responsibility to farmers in general and Respondents at bar.

Retention of a worthless interest or stock in a family business does not constitute a retention within the meaning of the absolute priority rule; the absolute priority rule applies only to public holders of corporate securities and not to individual debtors or alter ego holders of stock in family debtor corporations.

Secured creditors are estopped from voting their unsecured deficiency claims against the Plan to forward their secured interests.

Debtors do not receive or retain under their plan any property on account of any junior claim or interest they have against the estate.

The overriding principles of equity and fairness central to the Bankruptcy Code prevent the absolute priority rule from being applied inequitably and unfairly.



## ARGUMENT

### I. The Absolute Priority Rule Cannot Possibly Be Interpreted As Petitioners And The Solicitor General Suggest Without Working A Monumental Fraud On The American People And Distressed Farmers In Particular.

The issue of absolute priority has been raised in this case during a severe national financial crisis in farming.

While there has been a noticeable improvement in 1987, the plight of vast numbers of our grain farmers is still very precarious. (Brief of the States, p. 1[1]; Economic Research Service, U.S. Dept. of Agriculture, *Ag. Info. Bull.* No. 525; *Agricultural Letter*, Federal Reserve Bank of Chicago, July 3, 1987, No. 1711, reproduced in full as Appendix A).

At the outset, the Ahlers express gratitude to the four members of the Eighth Circuit Court of Appeals who averted, for the time being, a financial panic and sure destruction of the American farm economy by refusing to allow the absolute priority rule to be interpreted in such a way as to prevent distressed farmers from reorganizing. The *Ahlers* decision in the Circuit Court has saved many farmers from extinction by forcing the parties to bargain and has prevented our courts from being innundated with farm bankruptcies, foreclosures and repossessions, thus providing breathing space and halting any further precipitous decline in farm values and prices.

It is inconceivable that it was the intention of Congress, when it passed the new Bankruptcy Code in 1978, to leave

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[1] "Brief of the States" refers to the Amicus Curiae Brief filed by the Attorneys General of Arkansas, Connecticut, Iowa, Illinois, Kentucky, Minnesota, Montana, Nebraska, New York, North Dakota, South Carolina, South Dakota and Texas.

the nation bereft of effective laws to permit business to reorganize during a severe national financial crisis. This is precisely what the Solicitor General and Petitioners suggest by their arguments; for, it is axiomatic that creditors will always run for the door during such a crisis (the absolute priority rule as interpreted by Petitioners would permit them to do so).

As the current farm problem has proved so dramatically, it is not possible to accept at this late date in our history, the 19th Century concept that the American economy should be "let alone" and its corollary that lenders should be permitted to force liquidations at will because the assets are erroneously thought to belong to them.

Debtors believe that built into the cost of lending is the cost of providing a fresh start and a decent, effective chance to reorganize one's affairs (especially where the fault of financial failure is beyond the control of the borrower). Such is the obvious purpose of Chapter 11 reorganization. See *In re Star Builders, Inc.*, 62 B.R. 983 (Bkrtcy., W.D.Va. 1986).

It would be sad for our nation to be forced to conclude (i) that Congress has engineered a monumental fraud by purporting to grant broadly what it then renders null by such specific provisos as the "absolute priority rule," or (ii) that lender lobbies, pressure groups, or arms of the Executive Branch have been able to coerce Congress to perpetrate such a cruel hoax.

Debtors have no pressure groups or loud voices in Congress, for no one ever expects to be insolvent. Moreover, we have inherited an onus that attends insolvency from our English forebears who viewed insolvency as a crime. The erroneous and dangerous concept that lenders should



be able to force liquidations at will because the assets belong to them comes from an unenlightened period in English history when debtors prisons, treadmills and work houses were thought proper, and is not a principle that Americans now endorse or have knowingly included in their scheme of lending and borrowing. All of the States of the Union have laws which specifically prevent creditors from treating secured property as their own until title or possession passes to them by due process of law.

The Solicitor General of the United States, as Amicus Curiae, has submitted a brief which is eye-opening, but not in the way its authors have intended. By advancing, with arbitrary and heartless abandon, discredited theories which proved in the Great Depression of the 1930's to be very costly in terms of human suffering, the Solicitor General emphasizes how "creditor oriented" some voices in our government have become.

Apparently, the Justice Department has overbroad influence in Congress. For example, Respondents understand that the sponsors of the Chapter 12 Bill for the reorganization of family farmers were unable to get that legislation passed unless they agreed to Jusitce Department demands that the trustee system provided therein be funded by a ten percent surcharge on all disbursements under the farmer's plan of reorganization. This unfair and costly provision effectively prevents farmers from reorganizing under Chapter 12 and renders Chapter 12 legislation valueless. 11 U.S.C., sec. 1202(d). How could an insolvent debtor possibly be expected to pay such a surcharge, and by what possible right could our government demand it? It is untrue, as inferred by Petitioners and the Solicitor General, that Chapter 12 is a viable alternative for ailing small farmers.

Moreover, the Executive Branch has expressed deep concern over escalating costs of government and the unsupportable expansion of the public debt resulting from unwarranted intrusion of government in private affairs. This has not stopped the government from installing, at enormous cost, an all-pervasive and expanded U.S. Trustee system as "watchdogs" in every bankruptcy case in the nation. This, too, was a measure that accompanied the Chapter 12 legislation and has the effect of providing at taxpayers' expense, another attorney to represent the interests of creditors who can and will afford their own representation. Nor is it true that lenders have reduced their charges for loans because of the reimposition and alleged broadening of the absolute priority rule in 1978, as inferred by Petitioners and the Solicitor General.

Referring to the cram-down provisions of the Bankruptcy Code of which the absolute priority rule is part, one expert declared in 1979 (soon after passage of the Code), "At this writing, only one writer has represented that he understands those provisions, and even he describes an understanding of the Code cram down as requiring a 'tortuous journey through the statute and legislative history that is fraught with complex concepts, terms of art, and innuendo.'" Moller, *Chapter 11 of the 1978 Bankruptcy Code*, St. Mary's L.J., 437, 471 (1979), quoting Klee, *"All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code,"* 53 Am. Bankr. L.J., 133, 136 (1979).

Well might this Court ask, if bankruptcy experts cannot understand these provisions, then how could a general practitioner[2] located above the bank on Main Street

[2] The local practitioner, if he's lucky, will only do one Chapter 11 farmer reorganization case, for the Code provisions allowing him to collect a fee are so involved, onerous and riddled with pitfalls that his chances of reward are slight. All that he is likely to get for his trouble is much unfair criticism for his ignorance and incompetence. Lenders who can afford it, have, of course, employed the best talent available from the nearby city, so that there is no contest from the beginning. In practice, the "absolute priority rule," as interpreted by talented counsel for creditors, is just another tool of secured lenders to "grab" their collateral as soon as possible, for no realistic unsecured creditor, who does not have a secured claim, would ever invoke the rule to prevent the retention of a worthless "interest" by an insolvent debtor. The retention of such an interest by the debtor is vital to any recovery by such an unsecured creditor.



(upon whom farmers must depend) understand them? And, how could bankers and the government possibly reduce their charges for loans because of the absolute priority rule if even the experts did not know what those provisions meant?

The absolute priority rule is just one of the many substantial obstacles confronting farm debtors and their counsel. In too many instances, counsel finds it too expensive and difficult to take an adversarial posture and thus finds himself in the position of conducting what amounts to a decent funeral for debtor's business, i.e., gaining as much time as possible for the farmer so that he can order his affairs and move on to something else. Sometimes, the time involved is unmercifully short, and regrettably, that is another drawback of Chapter 12. The time to confirm and implement a plan is unrealistically short so that often a Chapter 12 proceeding becomes a lender tool to hasten the farmer's demise. The Chapter 12 procedure is not viable, especially since lenders have managed to persuade courts in many jurisdictions that debtors are not entitled to file or convert to Chapter 11 proceedings if Chapter 12 relief proves to be unavailing or chimerical.

Another drawback of Chapter 12 is the continuing jurisdiction of the Court and its Trustee over the affairs of the debtor, which is not only very costly, but unduly restricts debtor's capacity to run his business in the normal course.

This Court should not be misled by the inferences of Petitioners and the Solicitor General that Chapter 12 with its elimination of the absolute priority rule is a viable alternative for farmers.

Farm debtors cannot afford an absolute priority rule that defeats their reorganization efforts before they start.

As stated in the Federal Reserve's Agricultural Letter, July 3, 1977, p. 2 (App. 3a), there was a rapid escalation of farmland values throughout the Midwest between 1970 and 1980 and a corresponding enormous increase in debt. Farmland prices which had soared twelve-fold between 1950 and 1980 climbed four-fold between 1970 and 1980 in the Seventh Federal Reserve District. Farmland prices and all other farm prices were permitted to rise drastically in the face of radically increasing demands for farm products. (*Outlook*, *Wall Street Journal*, Mon. Aug. 26, 1985).

As conceded by the Federal Reserve, "U.S. domestic agricultural and macroeconomic policies inadvertently enhanced export opportunities of other nations," and the situation "was further exacerbated by domestic macroeconomic policies that contributed to the rising exchange value of the dollar." (Letter, p. 2, App. 4a, 5a).

As worldwide demand grew, inflation soared and interest rates rose to high double digits. The government told farmers to farm fence-to-fence to feed a hungry world and at the same time advised farmers that costly new machines and methods could greatly enhance production



and profits. Farmers were advised that they would perish if they did not keep up with the times. Lenders, government and agricultural suppliers urged farmers to expand and improve their operations or perish. Farm debt grew from $50 billion in 1970 to $200 billion in 1985. (See *Time Magazine*, 2/18/85, p. 27-8).

All of this was made possible by the government's change of lending rules in 1971. In 1971, the government stopped making farm loans on a farm's ability to repay from cash flow on its operations and instead started to lend on the highly inflated and inflatable market value of the farm. (*Wall Street Journal*, *Review and Outlook*, p. 22, 12/6/85)

Left out of the Federal Reserve's analysis are the facts that the government was not just partly responsible for the present farm crisis but almost entirely responsible for it.

By 1980, Congress had authorized farm loans up to an irresponsible 97% of those obviously inflated market values. (*Wall Street Journal*, *Review and Outlook*, p. 22, 12/6/85)

It was an old story. Farmers, who for generations had been taught by their fathers to beware of implement salesmen who advised farmers to go modern or go bust, were now assured by the government and the nation's most influential and respected lenders and agricultural leaders that a farmer would be left behind if he did not modernize and expand.

In 1981, the bubble burst when worldwide glut slashed demand for U.S. farm products abroad due to U.S. "macroeconomic policies."

Prices fell drastically and precipitously. Suddenly, without warning, farmers could not make enough from

crop sales to cover repayment of their loans. As farmers were forced to sell their equipment, livestock, and land to meet loan payments, prices dropped even further and the financial crisis became a nightmare. Over time, at least one-fourth of the nation's grain farmers found they had little or no equity in their land and many found they had large deficiency claims against them. As of January 1987, over forty-six (46%) percent of all U.S. farmers had a negative or zero cash flow (See *Brief of the States*, p. 1-3; *Time Magazine*, 2/18/85, p. 28)

The farm credit system admits it is insolvent and has received a government bailout in the billions to meet its commitments and assist farm debtors. Forty-two (42%) percent of the Department of Agriculture's Farmers Home Administration loans in Nebraska were delinquent and thirty (30%) percent of Iowa farmers with less than $800,000 in assets were behind in their payments as of February, 1985. (*Chicago Tribune*, Monday, February 4, 1985, "Bank Failure Tightens Noose on Rural Town.") The number of farm foreclosures escalated dangerously through 1986. Over 70,000 farms were lost in 1986 alone. The view that, if a farmer does not have the support of the secured creditors in a consensual reorganization, he cannot reorganize, reached full flower largely through the astounding influence of lenders and their governmental supporters.

The Ahlers are not governmental or private financial experts or lenders, captains of industry, Philadelphia lawyers, or agri-business leaders all of whom possess the means and capability of forecasting prudent courses of economic conduct. They are plain folks who must depend upon prominent persons in their community and the government for guidance. They have especially depended on the Federal Land Bank, Norwest Bank, and the U.S.



government to assist them, to forebear, to deal fairly with them in time of need and to help them through. That is the least they had a right to expect when they were caught up in a crisis not of their own making, but one entirely created by those who now demand their demise. It is incomprehensible that Norwest and the Federal Land Bank would prefer disastrous liquidation losses rather than performing loans on their books when the tide appears to have turned and farmers' (like the Ahlers') chances of reorganizing to the benefit of all of their creditors seems brighter. Equity is all on the side of the Ahlers. In no court has this been denied by the Petitioners.

If the government, agri-business, and lenders could be held in tort for their negligence and irresponsibility in creating the present farm financial crisis, the Ahlers and other farmers like them would be owed many billions of dollars.

The Ahlers do not ask for redress. They ask for an opportunity to pay their creditors a reasonable and fair amount through the process of reorganizing their affairs under Chapter 11, rather than deserting their creditors and cancelling their losses in a Chapter 7 proceeding. It is ironic that the government and Petitioners suggest an interpretation of the absolute priority rule that prevents the Ahlers from doing what is moral and right.

Judge H. Clyde Pearson, Bankruptcy Judge in the Western District of Virginia, summarized the matter very well when he found, in *Star City Rebuilders, Inc.*, 62 B.R. 983 (Bkrtcy., W.D.Va. 1986), that where a closely held family corporation reorganizes, retention of worthless stock in the corporation by the family members does not constitute a retention within the meaning of the cram

down (absolute priority) provisions of the Code, and does not prevent confirmation of the plan of reorganization.

Judge Pearson found that to require the family members to surrender their shares "would cause them to lose interest in rehabilitating the corporation . . . They would no longer have any desire to work in the day-to-day operation of the business, and would be inclined to liquidate the corporation under Chapter 7, allow the creditors to obtain what little recovery, if any, they may receive, and be done with the matter. Such a result would be contrary to the rehabilitative purpose of Chapter 11 and render its provisions meaningless."

He said further at 62 B.R. 988:

> We doubt that Congress intended the statute to be given an interpretation which destroys its central purpose and refuse to do so in this case.

That should be the ruling of this Court in this case.

### II. The "Absolute Priority Rule" Does Not Prevent The Ahlers From Confirming, Over Petitioners' Objections, The Fair Plan Suggested By The Court Of Appeals

11 U.S.C., § 1129(b)(1)(2)(B)(ii), commonly known as the "absolute priority rule," states:

> (b)(1) Notwithstanding § 510(a) of this title, if all of the applicable requirements of subsection (a) other than paragraph (8) are met with respect to a Plan, the Court, on request of the proponent of the Plan, shall confirm the Plan notwithstanding the requirements of such paragraph if the Plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the Plan.



> (2) For the purpose of this subsection, the condition that a Plan be fair and equitable with respect to a class includes the following requirements:
>
> (B) With respect to a class of unsecured claims—
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the Plan on account of such junior claim or interest in any property.

According to Petitioners, this absolute priority rule prohibits Debtors from retaining their proprietorship interest in their farm operation (unless they pay all unsecured creditors in full). Petitioners say that they would block any Plan because of their large unsecured claims (which result from a decline in the value of the collateral which secures their claims). Petitioners say they would dominate the unsecured class and thus be able to vote down any Plan in order to force a liquidation and distribution of the Ahlers' assets to them to apply to their secured claims. Finally, Petitioners contend that Debtors could not cram down their Plan because Debtors would be retaining an ownership interest in their farm business which is prohibited by the absolute priority rule.

It should be abundantly clear, however, that the absolute priority rule applies only to public holders of corporate securities but not to individual debtors or to alter ego holders of closely held stock in family corporations which are debtors.

In a corporate setting, equity shareholders and public holders of certain debt securities comprise "classes" under the Plan of reorganization which are invariably junior to the claims of unsecured creditors. If the corpora-

tion is insolvent, these junior equity and debt interests cannot be retained under the Plan without the permission of the unsecured creditors unless these creditors are paid in full or new and sufficient contributions are made by the holders of the junior interests. The rule is designed, not to assure that unsecured creditor's are always paid in full (they rarely ever are and ordinarily are paid only a fraction of their claims). The rule is designed to assure that unsecured creditors (who usually cannot risk a liquidation) have a bargaining position so that through negotiation they receive fair value for their claims as of the date of confirmation. The rule is designed not to force a liquidation, but rather to prevent liquidation through negotiation.

### A. A Secured Creditor Is Estopped From Voting Its Unsecured Deficiency Claim Against The Plan On An Inequitable Basis.

Because the Bankruptcy Code emphasizes the equitable treatment of creditors by debtors, often obscured is the Bankruptcy Code's similar insistence that all parties act equitably in the treatment of one another. Said another way, a bankruptcy court, as a court of equity, cannot be used to further an inequitable purpose. *Pepper* v. *Litton*, 308 U.S. 295, 304-5, 307-8 (1939); see also *Porterfield* v. *Gerstel*, 222 F.2d 137, 142 (5th Cir. 1955). A creditor, by filing his claim, has invoked the Bankruptcy Court's equitable jurisdiction. The creditor is thus not free to request an application of rules and laws which defeat their very purpose and results in gross unfairness and inequity to other creditors and debtors. A secured creditor is not at liberty to vote his unsecured position so as to cause a liquidation in which he can take all of the assets to satisfy his secured claim. By so doing, such a secured creditor prejudices and defeats the rights of all



unsecured creditors, he also defeats his own unsecured claim which he is supposed to be protecting. Such a secured creditor is not bargaining in good faith, for his aim is not to forward the Plan on a fair, equitable and reasonable basis or to negotiate his unsecured position on a fair basis. Rather he seeks to deprive unsecured creditors of their chance to recoup their losses and the debtor of his opportunity for a fresh start.

In order to avoid manifest injustice, and do equity, this Court devised the absolute priority rule in *Northern Pacific Railway Co.* v. *Boyd*, 228 U.S. 482 (1913). In that case, a secured lender and the stockholders of the insolvent railroad company agreed that the assets of the company would be sold at public auction to a newly organized railway company for an amount less than the secured debt. It was further agreed that the lender would share the stock of the new corporation. Upon the complaint of an unsecured creditor, who claimed his rights were superior to that of the shareholders, this Court found that if the value of the railroad justified the issuance of new shares, the creditors were entitled to the benefit of that value. The Court went on to say at 228 U.S. 508:

> *This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash* as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment Debtor, and, *having refused to come into a just reorganization, could not be heard in a court of equity to attack it.* If, however, no such tender was made and kept good he retains the right to subject the interest of the old stockholders in the property to the payment of his debt. If their interest is valueless, he gets nothing. If

> it be valuable, he merely subjects that which the law had originally and continuously made liable for the payment of corporate liabilities. (Emphasis supplied).

Although the rule has been adapted to the confirmation procedure in the Code, clearly one overriding principle stands out. In a Bankruptcy Court of Equity, not only must the Debtor act fairly but the claimant who asserts his rights must act fairly as well. A claimant who attempts to subvert the overriding equitable purpose of the Code by voting in derogation of the unsecured class of which it is part, *i.e.* to force a liquidation so that all assets can be delivered up to it in satisfaction of its secured claim, leaving the unsecured creditors including itself with nothing, does not act in good faith and cannot be heard in equity to oppose a just Plan of Reorganization, such as suggested in this case by the Eighth Circuit.

So at bar, Petitioners would be equitably estopped to assert their unsecured deficiency claims in derogation of the interests of the class to which they belong in face of the totally just and equitable Plan suggested by the Eighth Circuit Court of Appeals.

But even if this were not so, it is also clear that the Code or the Courts could not require Debtors to do that which this Court has described as impossible in *Boyd*. As sole proprietors, the Ahlers do not have income bonds or preferred stock to issue to the unsecured creditors. Consequently, the absolute priority rule in the Code could not possibly apply to individual debtors (or any debtor at all), but rather to security holders—just as it did in Chapter X of the now repealed Bankruptcy Act. This is easily perceived from the language used in 11 U.S.C., § 1129(b)(2)(B)(ii): "the holder of any claims or interest that is junior to the claims of such class will not receive or retain *under the Plan* on account of such junior claim or interest any property."



### B. Debtors Do Not Receive Or Retain Under Their Plan Any Property On Account Of Any Junior Claim Or Interest They Have Against The Estate.

Debtors do not receive or retain *under their Plan* their proprietorship interest in their farm business. Debtors retain or receive their proprietorship interest from the estate by operation of law outside of the Plan.

When Debtors filed their Petition in Bankruptcy, all of their property went to the bankruptcy estate of which they became trustees as Debtors-in-possession. Upon confirmation of their Plan, all property owned by the estate will revert to Debtors by operation of law. 11 U.S.C., sec. 1141(b). Consequently, there is, and never was, any reason for Debtors to provide for a distribution of their property to themselves *under the Plan*. No such property interests of Debtor, including proprietorship interests, are ever classified in a Plan, not because of inadvertance or misapprehension, but because no Plan is needed to distribute Debtor's property to themselves. The situation is not different in a corporate reorganization. The Debtor is the corporation and upon confirmation its property will be returned to it by operation of law and not under the Plan. However, the corporation has shareholders and bond holders who are parties separate and apart from the corporation whose interests and claims must be handled *under the Plan*. It is to such parties that 11 U.S.C., § 1129(b)(2)(B)(ii) refers—those parties who have junior claims and interests in the Debtor that need to be handled *under the Plan*. These parties are not the Debtors, for the Debtors have no such claims or interests.

True, there are a few bankruptcy cases which hold otherwise, but the Courts that decided them ignore the plain language of the Code and are misinformed.

The inconsistency of applying the absolute priority rule to property interests of the Debtor rather than the property interests of claimants or equity security holders and the like is best perceived in the reorganization of a family farm corporation.

In many cases, the farm land is owned individually by the farmer and his wife but the corporation may own the farm equipment. In this situation, Petitioner Federal Land Bank, as a lender on security of the land, would be a secured creditor of the individual Debtors while Petitioner, Norwest Bank, as a lender on the security of the equipment, would be a secured creditor of the farm corporation. Barring the complications of cross-collateralization or individual guaranty, the Federal Land Bank could not vote its unsecured deficiency claim to defeat the corporate plan of reorganization, since it is not one of the corporation's creditors. Similarly, Norwest Bank could not defeat the individual's plan of reorganization since it is not a creditor of the individual debtors.

The Solicitor General of the United States is insistent, in his brief, on putting across the patently false notion that when a business becomes insolvent, the assets belong to the creditors—for this is the only way confiscation of assets of the Debtor's estate, by blocking the reorganization Plan, might appear equitable. The assets of an insolvent Debtor, however, still belong to the Debtor until they are sold or otherwise conveyed by operation of law. When a Chapter 11 petition is filed they become part of the estate and revert to the Debtor on confirmation. 11 U.S.C. sec. 1141(b). At no time do these assets (property)



constitute a claim or interest against or in the estate or in debtors so as to make the absolute priority rule applicable. Indeed, if the assets belong to the creditors as alleged by the Solicitor General, the absolute priority rule could not apply at all, for debtor would have no interest.

The absolute priority rule is not concerned with the retention by debtors of their property. Rather, the rule is concerned with parties who have interests or claims against the Debtors and who must be treated equitably under the Plan according to the priority of their claims and interests.

Accordingly, the Ahler's Plan is not blocked by the "retention" of their proprietorship interest because such interest is not retained "*under the Plan*" as provided by the absolute priority rule. It is significant to note that the only time "interest" is explained in the Code is in connection with the definition of "equity security", thus demonstrating that the absolute priority rule applies only to such interests. 11 U.S.C., sec. 101(15).

### C. Any Property Interest That Is Retained Must Be Of Value To The Unsecured Creditors In Order For It To Fall Within The Purview Of The Absolute Priority Rule.

Clearly, if property has no value to unsecured creditors they are estopped from asserting a claim against any such assets and therefore cannot assert the absolute priority rule. If debtor possesses no more than bare title or an inchoate right valueless to creditors, the creditors are deprived of nothing if such a so-called "interest" continues in the possession of the reorganized debtor.

Since a corporation has a life of its own and continues on until dissolved, net worth is not the only measure of corporate value. The right to control may also have value,

or it also may not, as in a closely-held, insolvent family corporation that no one wants.

On the other hand, a sole proprietorship with a negative net worth has absolutely no value to the unsecured creditors, barring some very unusual circumstances which are not present in this case.

The Ahlers' sole proprietorship clearly has no value whatever to their unsecured creditors. All of the assets of the business are pledged as security and are totally unavailable to the unsecured creditors, as found by the Court of Appeals and as Petitioners concede. Without these assets there is no going concern value because there is no going concern. Without Mr. and Mrs. Ahlers, there are no sole proprietors.

Since the Plan suggested by the Eighth Circuit in essence requires the Ahler's to deliver up to the creditors all cash flow in excess of that anticipated in the Plan, there can be no question that the Ahlers do not retain property of value and, in any event, their contributions would exceed by far any possible reorganized going concern value claimed by the unsecured creditors. (Circuit Opinion, Joint Petition, Appendix A 24-26).

Be that as it may, the fallacy in requiring the Alhers to treat unsecured creditors in the handsome way suggested by the Circuit Court is revealed in the diametric difference between the public holders of corporate stock and individual ownership. The corporation is an on-going concern by its very nature and so long as it lives it is required to satisfy the legitimate claims of its creditors, both secured and unsecured (unless it can compose its debts within a Chapter 11 proceeding). Mr. and Mrs. Ahlers have no continuing obligation to farm for the benefit of creditors for the rest of their lives. To the contrary, the



Ahlers may simply deliver up their assets, receive a discharge of their debts, and go back to farming again. It is a tribute to farmers like the Ahlers that they desire to deal fairly with their unsecured creditors and resist the efforts of their secured creditors to put them out of business.

How can the unsecured creditors possibly complain when the Ahlers "retain their proprietorship interest" in order to pay the unsecured creditors far, far more than the zero they would receive in liquidation? The answer is that the real unsecured creditors are not complaining. It is the secured creditors, who wish to disenfranchise the unsecured creditors, by voting their deficiency claims, who are complaining.

Be that as it may, the Ahlers retain nothing when they continue to farm. The on-going concern value of their interest to creditors is zero before confirmation and after confirmation because the Ahlers' proprietorship interest, by definition, could never be sold to others for the benefit of creditors. Such a proprietorship in itself has no asset value. Consequently, an insolvent proprietorship is not "property" within the meaning of the absolute priority rule.

### III. The Absolute Priority Rule Recognizes That Ownership May Be Retained If There Is A New Contribution Of Skill And Labor Even Though Unsecured Creditors Are Not Paid In Full.

The Attorneys General of thirteen states have filed a splendid brief with this Court which exhaustively explains and demonstrates that a contribution of skill and labor will satisfy the requirement of new value set forth in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

As stated in the Court of Appeals opinion, at Joint Petition Appendix, p. 26:

> . . . The Ahlers would not realize any real profit or benefit from their retained equitable ownership interest until the reorganization plan was completed and the secured creditors had been paid the full amount of their allowed secured claims. At this time, the equitable ownership interest would mature. Thus, if the bankruptcy court determines that the value of the Ahlers' yearly contributions of labor, experience, and other expertise over the life of the plan will equal or exceed the value of the retained ownership interest at maturity, the dissenting unsecured creditors cannot complain that they have not been accorded their full right of priority against the debtors' assets.

This is especially true because admittedly, if the Ahlers were liquidated, the unsecured creditors would receive nothing (Jt. Petn. App. 47) and, in that event, all creditors would be far better off in the meantime, having received periodic payments under the plan (and, in the cases of secured creditors, appreciation of their collateral or, in the case of unsecured creditors, an opportunity to participate in unanticipated excessive cash flow).

Mr. Ahler's promise of his skills and labor so that he may reward his creditors beyond all standards of fairness is not only measurable in money's worth but far exceeds any requirements of the Bankruptcy Code including the absolute priority rule. As observed by the Attorneys General (Brief of the States, p. 5), owners who contribute their skill and labor as new value to the business do not thereby retain ownership *"on account of" their prior interest.* "Rather the source of their new interest in the reorganized business is their new contribution." Were it true that this Court's prior rulings in cases such as *Los*



*Angeles Lumber* were not embodied in the Code (as suggested by Petitioners and the Solicitor General) then it could just as easily be said that the absolute priority rule does not apply at all because the Ahlers *are not* retaining an interest *"on account of" any prior interest.* Considering the ingratitude and wanton rapacity of Petitioners and the government, such would be a just and deserved result in this case.

The Ahlers do not retain any property of value to the senior class of unsecured creditors. This is the only way that 11 U.S.C. 1129(b)(2)(B)(ii) makes any sense at all.

This case and the Court of Appeals holdings therein do not resemble *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); *Metropolitan Holding Co.* v. *Weadcock*, 113 F.2d 207 (6th Cir. 1940); *Spitzer* v. *Stichman*, 278 F.2d 402 (2d Cir. 1960); or *Muskegon Motor Specialties*, 366 F.2d 522 (6th Cir. 1966). These are cases involving efforts by shareholders to retain their shares by offering such vague and immeasurable contributions as "continuity of management," "financial standing," and "influence in the community." These are not measurable in money's worth, which was the reason they were rejected as valid contributions in *Los Angeles Lumber.*

The Ahlers' labor and skill are measurable in money's worth and are valid contributions to their plan.

As pointed out by the Attorneys General (Brief of the States, p. 11), promises and contingent financial support have been recognized as contributions of new value sufficient to satisfy the absolute priority rule. *In re Landau Boat Co.* 13 B.R. 788 (Bktrcy. W.D. Mo. 1981); *In re Potter Material Services, Inc.*, 781 F.2d 99 (7th Cir. 1986), *In re Brown's Industrial Uniforms, Inc.*, 58 B.R. 139 (Bkrtcy. N.D. Ill. 1985).

A farmer's skill and labor, however, are nowhere nearly as risky as a promise to make a loan in the future (*Landau*), a personal guaranty *(Potter)* or a pledge of personal assets *(Brown)*, since the capability of performing these can easily be lost. Only death or serious illness of Mr. Ahlers could prevent the plan from being fully consummated.

We agree with the Attorneys General that application of the so-called "exception" in *Boyd* as explained in *Los Angeles Lumber*, should not be translated into a rigid rule. Rather the exception should be as flexible as the "fair and equitable" principle that overrides and governs it. It should be an easily available alternative, however, because only then is the central prophylactic purpose of the Bankruptcy Code achieved—the prevention of loss for all creditors and the estate, not just secured lenders with unsecured claims to vote, or other narrow, selfish interests.

America does not need a Bankruptcy Code that is interpreted to promote the "self cleansing" feature of "free market" economics, lauded so highly by those it never affects. That notion is nothing new. Charles Dickens spoke of it when the theory was in full bloom in the 19th century England:

> "Are there no prisons?" asked Scrooge.
>
> "Plenty of prisons," said the gentleman, laying down the pen again.
>
> "And the Union workhouses?" demanded Scrooge. "Are they not still in operation?"
>
> "They are. Still," returned the gentleman, "I wish I could say they were not."



> "The Treadmill and the Poor Law are in full vigor, then?" said Scrooge.
>
> "Both very busy, sir."
>
> "Oh I was afraid, from what you said at first, that something had occured to stop them in their useful course," said Scrooge. "I am very glad to hear it."
>
> —*A Christmas Carol*, by Charles Dickens

America and its farmers need a fair, equitable and reasonable interpretation of the Bankruptcy Code that preserves the rights of all, provides breathing space in the time of crisis, and prevents the unfair and unnecessary "cleansing" of persons and businesses from the economy to the enhancement of the general welfare.

## CONCLUSION

The holding of the Court of Appeals forwards the intent of Congress to provide a fresh start and realistic opportunity to reorganize. The proposition—that an owner's contribution of future labor should permit him to retain his worthless equity interest in order to pay his creditors fair value under a plan of reorganization—was never proposed to Congress and rejected. Moreover, there is no immediate, foreseeable risk being shifted to creditors, and certainly no risk being shifted to unsecured creditors, who are the only class with status to complain at bar. The decision of the Court of Appeals should be upheld.

Respectfully submitted,

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# APPENDIX

# APPENDIX A

**Agricultural Letter, Federal Reserve Bank of Chicago, July 13, 1987, Number 1711**

**A historical perspective on District agriculture**

Agricultural production in the Seventh Federal Reserve District centers on the production of feed and livestock products. Five commodities, corn, soybeans, hogs, cattle, and milk, typically account for almost 90 percent of the marketing receipts of District farmers. Because of this concentration and the fluctuating forces that have influenced supply and demand for these commodities, the District's agricultural sector has undergone marked changes since the early 1970s.

A sharp rise in corn and soybeans output during the 1970s was spurred by an increase in the demand for these commodities. Domestic utilization of corn increased by 30 percent while soybean use rose 45 percent. Corn used for feeding livestock and poultry, which accounts for the bulk of domestic corn demand, rose by a fourth during the period. Use of corn for food, seed, and industrial purposes, although only a small component of domestic demand, jumped more than 75 percent between 1970 and 1980.

Although the increase in domestic utilization was substantial, the major impetus for the expansion of corn and soybean output came from the burgeoning world demand for U.S. grains and feeds. Overall U.S. agricultural exports rose at an unprecedented annual rate of 8 percent during the 1970s. During that period the U.S. share of world coarse grain trade grew from about 40 percent to more than 70 percent. Corn exports, the principle component of the nations' coarse grain exports, grew at an annual compound rate of almost 16 percent. Soybean exports grew at a rate in excess of 6 percent per year and consistently held a world market share of about 80 percent. Combined with strong domestic demand, the rise in exports ushered in a boom period for Midwest grain farmers.

Farmers in District states reponded to the growing demand in world grain and oilseed markets by greatily expanding output. By the early 1980s, corn acreage harvested in District states had jumped about 28 percent from the decade-earlier level, with large increases recorded in every District state and particularly in Michigan and Wisconsin. Moreover, impressive gains in per acre yields boosted output even more, resulting in District-wide production in the early 1980s almost 60 percent above the levels of ten years earlier. During the same period, soybean production in District states increased more than 64 percent paced by a 43 percent rise in harvested acreage.

This shift toward crop production to supply an expanding world market contributed further to a reduction in the importance of livestock production that had been occurring for some time in most areas of the District. After accounting for almost two thirds of total cash receipts in the mid 1960s, livestock marketings had fallen to less than half of the total receipts generated by District farmers by 1980. Only Iowa and Wisconsin were generating more receipts from livestock marketings than crop marketings among the District sales at the end of the 1970s.

Much of the falloff in livestock receipts is attributable to the decline of the cattle feeding industry in District states. In the mid 1960s, the District accounted for almost a third of the cattle in feedlots across the United States, with Iowa the number one cattle feeding state in the nation. The 1970s, however, saw a sharp cut in cattle feeding across the District, despite an increase of almost 10 percent nationwide. By 1980 cattle feeding in the District was down about a fourth from ten years earlier.

Hog production in District states largely followed the national trend during the 1970s. In the mid 1960s, District states accounted for more than half of the nation's inventories of hogs and pigs, with Iowa alone accounting for a fourth of the total. By the end of 1980, however, inventories of hogs and pigs on farms in District states increased about 17 percent. As a



result, the District's share of total inventories slipped slightly to 46 percent, although Iowa retained its dominant position within the industry.

The shift in resources away from livestock toward crop production in the 1970s is also evident in milk production trends among the District states. In 1980, milk output in the five state region was down about 2.5 percent from the level of the mid 1960s, compared to a 3.5 percent gain in production for the nation as a whole. Moreover, sharp reductions in four of the states were largely offset by a substantial increase in output in Wisconsin. The largest grain producing states in the District, Illinois, Indiana, and Iowa, saw milk production decline by 25 percent to 34 percent during the period. The importance of dairy output in the region, therefore, was maintained by a 19 percent increase in output by Wisconsin dairy farmers.

The increases in crop receipts contributed to rising farm income and a rapid escalation in farmland values throughout the Midwest. Farmland in District states was no exception, registering more than a four-fold increase in value during the decade of the 1970s. However the rapid increase in values was accompanied by a substantial increase in the amount of debt held by District farmers.

The rise in debt was particularly rapid in the second half of the 1970s. Between 1974 and 1979, the proportion of farm operators with debt in District states jumped from 42 percent to 63 percent. In comparison, 54 percent of farm operators nationwide had outstanding debt in 1979. In addition to the substantial increase in the incidence of debt across the District, the average amount outstanding to these indebted farmers doubled between 1974 and 1979.

The huge increase in debt contributed further to the overall escalation in farm production expenses. By 1979, interest expenses among District states had jumped more than 150 percent from the 1974 level, and continued to rise sharply into the early 1980s. Other production expenses were up 54 percent. Despite the increases in interest and other expenses,

farm income remained strong. Real net farm income in the District, an inflation adjusted measure of the value of a given year's production whether it is sold, fed to livestock or held in inventory, averaged more than 11 percent higher in the 1970s than during the 1960s.

The boom period for agriculture which characterized the 1970s ended abruptly in the early 1980s. Exports, which had fueled the expansion of crop production, dropped off sharply, pressuring prices and income lower. Moreover, the huge expansion of debt in the late 1970s was compounded by the sharp escalation of interest rates in 1980. By 1982, interest expenses among District farmers had climbed to more than $4.8 billion, 67 percent above the high 1979 level. As a result, many of the District's highly leveraged farm operators were experiencing severe financial stress.

The drop in U.S. agriculture exports in the 1980s is the result of a combination of forces. The worldwide recession of the early 1980s had a deleterious effect on U.S. agricultural exports. Stalled economic growth limited export demand and persistent debt problems and foreign exchange shortages in many regions of the world further dampened demand. In addition, increased production and exports by countries other than the United States contributed to mounting competitive pressures.

The success that other exporting countries have enjoyed in competing with the U.S. agricultural exports in recent years is attributable to a number of factors. Among these factors are large production and export subsidy policies of many exporting nations. In addition, U.S. domestic agricultural and macroeconomic policies inadvertently enhanced the export opportunities of other nations.

Following the inflation experience of the 1970s, farm price supports in the United States were designed to cover anticipated increases in production costs. However, increased world production pressured commodity prices lower, leaving U.S. support prices above market clearing levels and resulting in



disastrous consequences for U.S. agricultural exports. Rather than being directed toward export channels to satisfy demand at the prevailing world price, U.S. commodities moved under loan and into inventories. The void this movement created was then filled by competing exporters. The situation was further exacerbated by domestic macroeconomic policies that contributed to the rising exchange value of the dollar.

Despite the falloff in exports of major District commodities, production continued to expand. With price and income support payments insulating farmers from the effects of lower exports, producers responded with record corn crops in 1981 and 1982 and near record soybean output. Crop inventories began to build to burdensome levels. To alleviate this problem, the government instituted the Payment in Kind program (PIK) in 1983, which paid farmers in commodities to reduce their acreage of grains and cotton.

District farmers producing corn and other feed grains participated heavily in the program, sharply reducing acreage. Corn acreage harvested dropped 27 percent from a year earlier, but a severe drought further trimmed District corn production to about half the previous year's level. The drought also curtailed soybean production in District states, dropping it by about a fourth from the 1982 level.

The PIK program, combined with the drought, boosted feed grain prices sharply, transferring the financial stress that had been experienced by grain farmers to livestock producers. High feed costs accentuated the decline of cattle feeding in the District and severely squeezed the operating margins of all livestock enterprises. By the end of 1986, the number of cattle on feed in District states had dropped another 32 percent from the 1980 level, compared to a 6 percent drop nationwide. Low and negative operating margins for hog producers following the PIK and drought reduced feed grain crop of 1983 contributed to a 15 percent decline of hog inventories in District states in 1985 compred to five years earlier.

Milk production continued to rise in the early 1980s, requiring large government purchases of manufactured dairy products to support prices. In an effort to cut surplus production and reduce the costs of the support program, the government instituted a paid diversion program for milk producers in 1984. The program along with high feed costs had the short term effect of cutting U.S. output by 3 percent from a year earlier in 1984. However, with milk support prices remaining relatively high, milk production rebounded in 1985 after the end of the program, rising 6 percent above a year earlier in the District and nationwide.

The very short term effectiveness of the diversion program prompted the introduction of the whole-herd Milk Termination Program that took effect in 1986. Under the terms of the program, participants were required to liquidate their dairy herds and refrain from producing milk for at least five years in exchange for government payments based on past production. In District states, participating farmers represented about 5.4 percent of the region's 1985 milk marketings compared to participation equivalent to 8.7 percent of 1985 marketing nationwide. While the program has been effective in cutting projected milk production through most of 1987, it appears likely that low feed costs will continue to boost output per cow and that following the final herd liquidations, gains in milk production will resume.

Declining receipts and mounting expenses pressured income and land values in the 1980s. Despite a huge increase in government payments, which have averaged more than $6 billion in the 1980s compared to $2 billion in the previous decade, net farm income declined. Among District states, inflation adjusted net farm income in the first half of the 1980s averaged less than half the level of the 1970s. The declines were most pronounced in Illinois, Indiana, and Iowa, ranging from almost 60 percent to more than 70 percent lower than the previous decade. Inflation adjusted net farm income nationwide in the first half of the 1980s averaged 39 percent lower than in the 1970s.



The steep decline in net farm income precipitated a huge reduction in District farmland values. By the end of 1986, farmland values across the District had plummeted to about half of their 1981 peak. Adjusted for inflation, the decline was about 60 percent from the peak. As a result of the drop, the wealth that had accumulated to farmland owners during the 1970s was completely eroded. While the drop in net worth undermined the financial positions of all producers, for some it resulted in insolvency.

Through attention and efforts to restructure balance sheets and streamline operations, farmers have been adjusting to the economic realities of the 1980s. Although farm debt continued to expand through 1983, it has declined steadily since that time. By the end of 1985, outstanding farm debt among the District states (excluding price support loans from the CCC) had dropped almost 11 percent from the 1983 peak. With farm debt nationwide registering a further 8 percent decline last year, it is likely that outstanding among District farmers will continue to fall as well.

The sharp declines in debt, along with generally lower intrest rates, have contributed to lower production expenses. Paced by a 16 percent decline in interest expenses between 1982 and 1985, total production expenses of District farmers fell by more than 6 percent over the period. Although data for individual states is not available, farm expenses nationwide fell sharply again last year, suggesting that even further declines among District states occurred.

Lower production expenses and greatly improved returns to livestock producers over the last two years along with large government payments have contributed to improving prospects for a recovery in the farm sector. Further encouraging signs for District farmers are evident in export trends. Although soybean exports continue to be pressured by stiff competition from Southern Hemisphere producers, a substantial rebound in corn and feed grain exports has occurred this year. Coarse grain exports in the current year are expected to

increase almost a fourth from the dismal level of a year ago. Production setbacks in some regions of the world, greater use of export subsidies by the United States, and the lower exchange value of the dollar have contributed to the recent recovery of exports. Most importantly, however, the introduction of generic PIK certificates increased market supplies and pressured prices lower, effectively circumventing the loan rate price floor.

Peter Heffernan

# MOTION

MOTION FILED
JAN 7 1988

No. 86-958

In The
# Supreme Court of the United States
October Term, 1987

NORWEST BANK WORTHINGTON and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,
*Respondents.*

## MOTION FOR LEAVE TO FILE REPLY BRIEF OUT OF TIME AND JOINT REPLY BRIEF OF PETITIONERS

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*Respondents.*

## MOTION FOR LEAVE TO FILE REPLY BRIEF OUT OF TIME

Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul, pursuant to Supreme Court Rule 35.3, move the Court for leave to file their reply brief out of time.

In support of their motion, Petitioners state as follows:

1. In the *amicus curiae* brief in support of Respondents submitted by various state Attorneys General, reliance was placed upon an unpublished article, R. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute*

*Priority and New Value Contribution*, 36 Emory L. Rev. — (to be published 1988). Petitioners initially delayed submission of a reply brief pending publication of that article, and obtained a copy of the printer's proofs of the article on or about December 30, 1987.

2. Through oversight of counsel, preparation of the reply brief incorporating responses to the Nimmer article was not completed within the time provided by former Supreme Court Rule 35.3.

3. The text of Petitioners' proposed reply brief is submitted with this motion. The substance of the proposed reply brief is limited to certain matters raised in the briefs of Respondents and their *amicus curiae* supporters, and Petitioners respectfully request that their proposed reply brief be considered by the Court in this proceeding.

Dated: January 6, 1988

Respectfully submitted,

/s/ Gordon B. Conn, Jr.
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No. 86-958

In The
# Supreme Court of the United States
October Term, 1987

NORWEST BANK WORTHINGTON and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,
*Respondents.*

## JOINT REPLY BRIEF OF PETITIONERS

Petitioners Norwest Bank Worthington and Federal Land Bank of St. Paul submit this Reply pursuant to Supreme Court Rule 35.3 in response to Respondents' Brief.

## ARGUMENT

### I. Petitioners are not estopped from using the Absolute Priority Rule to oppose Respondents' plan of reorganization.

Respondents assert that Petitioners, as secured creditors, are somehow e topped from opposing the plan of re-

organization (Brief, pp. 14-17). In this Chapter 11 proceeding, Petitioners are secured creditors and, by reason of decline in the values of their collateral, unsecured creditors for the unsecured balance of their claims. Respondents admittedly have no equity in Petitioners' collateral, and Petitioners sought relief from the automatic stay in order to proceed with foreclosure. The Bankruptcy Court and District Court each granted relief from the stay, with the District Court finding that Respondents' financial position demonstrated the "utter unfeasibility" of their reorganization. (Pet. App. A86). By opposing a plan of reorganizatioon that would subject Petitioners to still further risk, Petitioners are simply exercising their statutory rights under the Bankruptcy Code and seek to proceed with foreclosure of their interests in property.

Narrowly viewed, the issue of absolute priority in this proceeding involves the rights of priority as between unsecured creditors and ownership by proprietors or shareholders. But, as recognized by participating counsel for the *amicus curiae* Attorneys General,[1] statutory priorities between classes in bankruptcy reorganization are part of the overall legal framework that provides rights and risks in negotiation for reorganization. Upsetting the balance between two classes may affect other classes as well, and, as in this case, result in a profound alteration of the priorities enacted by Congress.

The decision in *Ahlers* that an owner may retain property over the objection of unsecured creditors by a

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1. See Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L. Rev. — (to be published 1988) at pp. 3-4 (printers proofs).



promise to contribute future labor and management not only contravenes the direct statutory rights of unsecured creditors but also results in a dramatic impairment of the rights of secured creditors holding interests in the debtors' property. Chapter 11 of the Bankruptcy Code effected a departure from prior law by permitting a reorganized debtor to retain property subject to a mortgage or security interest notwithstanding the absence of any equity in the property. Where such property is necessary to an effective reorganization, the secured creditor cannot get the automatic stay lifted to permit foreclosure. 11 U.S.C. § 362(d)(2). Moreover, for the debtor to retain the property in reorganization, it may "cram-down" a plan over the objection of the undersecured creditor by providing for secured payment of only the "allowed secured claim" —i.e., the value of collateral at the time of reorganization. 11 U.S.C. § 1129(b)(2)(A). The balance of the creditor's claim is treated as an unsecured claim.

The Absolute Priority Rule protects rights not only of unsecured creditors but the property interests of secured creditors as well: a reorganized debtor may retain property subject to a mortgage only if the creditors consent or the plan provides for full payment of both the secured *and* the unsecured claims. Without the prohibition of the Absolute Priority Rule, a bankruptcy debtor would be given a *carte blanche* to defeat the property interests of secured creditors through a plan providing for payment of only whatever value the collateral has at the time of reorganization, with not even a promise ever to pay any portion of the unsecured claims.

It is precisely in this context that the absolute priority issue arose in *Ahlers*, and the ultimate effect of the

*Ahlers* decision is to render illusory foreclosure rights of secured creditors in bankruptcy. Under *Ahlers*, a debtor may retain property in which creditors had a secured interest through a "cram-down" plan premised upon reduced collateral value but without having provided any adequate protection of the creditors' interest under 11 U.S.C. § 362[2] and without even a promise eventually to repay the unsecured portion of the debt. Under *Ahlers*, a debtor may thus retain property previously mortgaged to creditors simply by a promise to work in the future in order to pay only the reduced indebtedness reflected in the allowed secured claim in bankruptcy. But such a promise was implicit in incurring the original indebtedness, and by promising in reorganization to work to repay the reduced indebtedness under the plan, the debtor in reality is contributing nothing new but is retaining property for a reduced price. The result is a severe impairment of the rights of secured creditors. By opposing such a plan, Petitioners are simply exercising their statutory rights under bankruptcy priorities established by Congress.

## II. There is no basis under Chapter 11 for applying different standards of absolute priority where the debtor is an individual proprietor rather than a corporation or other entity.

Both the Respondents (Brief, p. 13) and their supporters (Attorneys General Brief, pp. 17-20) argue that the absolute priority provisions of 11 U.S.C. § 1129(b)(2)

2. Under *Ahlers*, a creditor could not foreclose for lack of adequate protection because no obligation to provide such protection would arise prior to confirmation of a plan—see *Ahlers* (Pet. App. A10).



(B) should not apply where the debtor is an individual as opposed to a corporation having numerous shareholders. That argument reflects frustration with the fact that even if the "new value" exception to absolute priority under *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), remains available under Section 1129 of the Bankruptcy Code, an individual proprietor in a Chapter 11 proceeding may not have outside resources from which to make a new capital contribution sufficient to justify retention of ownership of the reorganized enterprise. That frustration, however, properly is directed to matters of legislative policy, not statutory interpretation.

Respondents' argument that the Absolute Priority Rule applies only to public holders of corporate securities and not to individual debtors is wholly without support in Section 1129(b) or anywhere else in the Bankruptcy Code. The legislative history is to the contrary. Prior to adoption of the Bankruptcy Code, Congress considered bills containing separate reorganization provisions for publicly held corporations and individuals or non-public companies. *See* H.R. 32, 94th Cong., 1st Sess. (1975); S. 236, 94th Cong., 1st Sess. (1975). These bills, which paralleled the reorganization provisions of the existing Bankruptcy Act, were not adopted. Instead, Congress specifically departed from the scheme under the Bankruptcy Act and combined both individual and corporate reorganization into a single chapter.

In doing so, Congress made no provision for applying absolute priority differently to individuals than to corporate shareholders, and declined to enact the specific proposal of the Bankruptcy Commission, H.R. Doc. No. 137,

93d Cong., 1st Sess. 254-259 (1973). Instead, Congress has enacted numerous other special provisions to deal with the needs of individual debtors and farmers. For example, under a Chapter 7 liquidation, only an individual debtor may obtain a total discharge of indebtedness. 11 U.S.C. § 727. Only individuals may exempt property from a bankruptcy estate and avoid certain liens on such property. 11 U.S.C. § 522. Unlike other debtors, farmers are not subject to involuntary bankruptcy proceedings. 11 U.S.C. § 303(a). To facilitate individual and farmer reorganizations, Congress has enacted both Chapter 13 of the Bankruptcy Code, 11 U.S.C. §§ 1301, *et seq.*, and Chapter 12, 11 U.S.C. §§ 1201, *et seq.* Under both of these chapters, the absolute priority requirements of which Respondents complain are eliminated.

With respect to Chapter 11 proceedings, however, there is no such avoidance of the Absolute Priority Rule. As the *amicus curiae* Attorneys General recognize, Congress was well aware of the problems posed by absolute priority in individual reorganizations, and dealt with those problems in the 1952 amendments to Chapters XI, XII, and XIII of the Bankruptcy Act, amendments designed to remove the "fair and equitable" provision (Attorneys General Brief, p. 7). But, as also recognized by the Attorneys General, in enacting the absolute priority provision of Section 1129 "Congress chose to use the term 'fair and equitable' to define plan confirmation standards" (Attorneys General Brief, p. 8). Indeed, in doing so, Congress specifically defined "fair and equitable" to preclude retention of property over the objection of senior creditors. 11 U.S.C. § 1129(b)(2).



The conclusion is inescapable: had Congress so chosen, it could have enacted the recommendation of the Bankruptcy Commission or made special exceptions to the Absolute Priority Rule for individuals, farmers, or small businesses. It chose not to do so, and Respondents' frustration is properly directed to Congress, not to the courts.

## III. Even if the new value exception of Los Angeles Lumber survives enactment of Section 1129, Respondents' promise of future labor, management, and expertise fails as a matter of law.

Both Respondents and their supporters challenge the argument of the Solicitor General that Section 1129 of the Bankruptcy Code precludes former owners from receiving or retaining property under a plan over the objection of unpaid creditors notwithstanding a contribution of new value as contemplated in *Los Angeles Lumber*. Regardless of whether this so-called exception to absolute priority remains available, it is clear that the future labor, management, and expertise of Respondents is insufficient to permit retention of ownership over creditors' objection.

Respondents first claim that they are retaining no property because their interest in the property retained has no value. This "no-value" theory provides that because there is no equity in the reorganized enterprise over and above the amount required to pay—over time—the allowed secured claims equal to the value of the secured creditors' collateral, the interest retained is worthless and therefore is not a "retention" under the Absolute Priority Rule (Brief, pp. 2, 19-21). That argument is without merit. Any time that a bankruptcy estate consists of property subject to secured claims, and those creditors are

undersecured, the debtor's residual equity interest by definition is of zero value; the "no-value" theory would enable a debtor in each such case to propose a plan to repay only secured creditors only the secured portion of their claims with the debtor to retain all property free and clear of any other claims. That approach effectively would nullify the Absolute Priority Rule, and has been rejected by most courts[3] and in a publication by co-counsel for the *amicus curiae* Attorneys General.[4]

Respondents next argue that *Ahlers'* provision for them to contribute future labor, experience, and expertise is sufficient "new value" to warrant retention of ownership under *Los Angeles Lumber*. The first problem with this argument is that the value is not new. Any time a debtor borrows money for use in his or her business operation, implicit in the promise to repay is the debtor's promise to work in the business to obtain funds to repay the loan. In this light, Respondents' promise of future work is not new, but only an extension of their earlier promise; this time, however, the promise would be only to work to permit repayment of written-down debt at the level of the collateral value rather than the original obligation. So viewed, the debtors are contributing nothing new.[5]

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3. *See, e.g., In re East*, 57 B.R. 14 (Bankr. M.D. La. 1985); *In re Pecht*, 53 B.R. 768 (Bankr. E.D. Va. 1985); *In re Modern Glass Specialists*, 42 B.R. 139 (Bankr. E.D. Wisc. 1984); *In re Genesee Cement, Inc.*, 31 B.R. 442 (Bankr. E.D. Mich. 1983); *In re Huckabee Auto Company*, 33 B.R. 132 (Bankr. M.D. Ga. 1981); *In re Landau Boat Company*, 8 B.R. 436 (Bankr. W.D. Mo. 1981); *but see In re Star City Rebuilders, Inc.*, 62 B.R. 983 (Bankr. W.D. Va. 1986).

4. *Amicus Curiae* Attorneys General rely upon a yet unpublished article by one of their counsel for affirmance of the *Ahlers* decision. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L. Rev. — (to be published 1988). In that article, Professor Nimmer rejects the no-value theory espoused by Respondents and in *Star City Rebuilders*, stating: "as a matter of policy, courts should reject this "no value" analysis, and indeed, most courts have rejected it (citation omitted). . . . Ownership, even of nominally worthless stock, amounts to retention of ownership on account of the prior interest in express violation of Section 1129(b)." *Id.*, pp. 40-41 (printers proofs).



Finally, Respondents and their supporters argue that the debtors' promise to furnish future labor, management, and expertise is the equivalent of a capital infusion sufficient to defeat the Absolute Priority Rule. Initially, one may quarrel with the value to be placed upon the management and expertise of individuals whose prior management and expertise resulted in bankruptcy, but there is a more fundamental flaw to the argument. A present capital infusion, a third-party guaranty, or a pledge of other assets outside the bankruptcy estate to fund a reorganization plan all have one common characteristic: if the reorganized operation fails, such new value constitutes an asset available to pay the obligations under the plan of

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5. The Attorneys General argue that an individual debtor's post-bankruptcy income is not part of the bankruptcy estate under 11 U.S.C. § 541, and that application of that income to fund a plan of reorganization is therefore "new value" (Attorneys General Brief, pp. 12-13). That argument, however, suggests that whenever an individual debtor promises to work in a reorganized business he is entitled to retain his ownership interest. As the Attorneys General recognize, "[s]uch a rule would go too far." *Id.*, p. 13. Where, as here, the property sought to be retained is subject to a mortgage or security interest, under Chapter 7 a debtor may reaffirm the indebtedness in order to retain the property. 11 U.S.C. § 523(c). The Absolute Priority Rule is the analogous feature of Chapter 11—the debtor may retain such property over objection only by agreeing to pay the unsecured portion of the claims in full.

reorganization. An unenforceable promise of future labor and management is fundamentally different: because the debtors are not contributing any new capital nor reaffirming their indebtedness or even agreeing to any repayment of unsecured creditors, if the reorganized operation fails, there is no "new value" to which the creditors can look for payment. Under the *Ahlers* plan, the debtors would retain their property and business, use the property to earn a living, and pay something to unsecured creditors only if the operation were successful; if the operation should fail, the debtors would have no further obligation, and the secured creditors would bear risk of further loss. That is precisely the result prohibited both by the Absolute Priority Rule and by this Court in *Los Angeles Lumber*.

## CONCLUSION

The requirements of Section 1129(b)(2)(B) are clear and the courts are not free to disregard them. The Respondents will receive property under their proposed plan in this case and unsecured creditors will not be paid in full. Petitioners have expressed their opposition to the proposed plan and their intent to vote against the plan, as is their right under 11 U.S.C. § 1126(a). Under *Los Angeles Lumber*, Respondents must contribute new capital in order to receive any property under the plan. The offer of labor and management skill by Respondents simply is not new value or capital. In addition, Respondents cannot avoid the requirements of Section 1129(b)



(2)(B) simply because the debtor in this case is not a public stock corporation. The decision of the United States Court of Appeals for the Eighth Circuit must be reversed because it is contrary to the provisions of Section 1129(b)(2)(B) and, to the extent applicable, this Court's decision in *Los Angeles Lumber*.

Dated: January 6, 1988

Respectfully submitted,

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# AMICUS CURIAE

# BRIEF

Supreme Court, U.S.
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# In the Supreme Court of the United States

OCTOBER TERM, 1987

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NORWEST BANK WORTHINGTON and FEDERAL LAND BANK OF ST. PAUL, PETITIONERS

*v.*

JAMES R. AHLERS and MARY M. AHLERS

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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## QUESTION PRESENTED

Whether a plan of reorganization under Chapter 11 of the Bankruptcy Code may be confirmed without the assent of a class of unsecured creditors whose claims are impaired and who do not receive property of a value equal to the allowed amount of their claims, if the plan allows the debtor to participate on the basis of future contributions of "labor, experience, and expertise."

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---

## BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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### INTEREST OF THE UNITED STATES

The United States and its agencies are often creditors in bankruptcy proceedings. For example, the Internal Revenue Service is a creditor in a very high percentage of bankruptcy proceedings because of federal taxes owed by the debtor. Other agencies, such as the Farmers Home Administration of the Department of Agriculture and the Small Business Administration, make loans to private parties, some of which enter bankruptcy before repaying the loans. Still other agencies, such as the Federal Deposit Insurance Corporation, become creditors in bank-

ruptcy proceedings because of the failure of entities that they insure. The question presented by this case affects the rights of creditors vis-à-vis debtors. The United States therefore has an interest in the proper resolution of that question. The United States filed a brief at the petition stage of this case at the invitation of the Court.

## STATEMENT

1. This case arises from the bankruptcy petition of respondents James and Mary Ahlers. Respondents farm land in Nobles County, Minnesota. Between 1965 and 1982, they obtained four loans from petitioner Federal Land Bank (FLB) and secured each of these loans with a separate parcel of land they owned (Pet. App. A3). Between 1982 and 1984, respondents obtained additional loans from petitioner Norwest Bank Worthington (Norwest). The security for these loans was a second mortgage on the property already securing FLB's loans and a first mortgage on respondents' farm machinery, farm equipment, crops, livestock, and other farm proceeds (*id.* at A4).

Respondents defaulted on their loans. Norwest, exercising its rights as a secured creditor, filed a replevin action in Minnesota state court seeking possession of respondents' farm equipment and machinery (Pet. App. A4). Two weeks later, respondents filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 1101 *et seq.* (Pet. App. A4-A5). This petition automatically stayed Norwest's collection efforts in state court (11 U.S.C. (& Supp. III) 362(a)).

2. a. Petitioners filed motions in the bankruptcy court for relief from the automatic stay, see 11 U.S.C. (& Supp. III) 362(d), asserting that respondents could not provide them adequate protection. The court, after examining respondents' financial situation, agreed with petitioners and lifted the stay (Pet. App. A63-A66). Respondents appealed this decision to the district court.

b. The district court denied respondents' motion to stay petitioners' collection efforts pending its resolution



of the appeal, but it agreed to enjoin petitioners from initiating any foreclosure proceedings pending appeal of the denial of the stay motion to the court of appeals. The court of appeals issued a stay and remanded the case to the district court for adjudication of respondents' appeal (Pet. App. A75-A77). In so doing, the court noted that respondents' 1985 crops were not subject to any liens and that those crops "have a value sufficient to reasonably insure that neither creditor will be further harmed if foreclosure and repossession proceedings are stayed" (*id.* at A76). The court gave petitioners a lien on those crops, ordered respondents to provide Norwest with assurances that all farm machinery and equipment was fully insured, and requested that the district court determine the merits of the request for relief from the automatic stay, including the probability of success of respondents' proposed plan of reorganization (*id.* at A76-A77).

c. The district court affirmed the bankruptcy court's order granting petitioners relief from the automatic stay (Pet. App. A84-A86). The court held that the factual findings of the bankruptcy court, which were not clearly erroneous, required that petitioners' interests be given adequate protection, and that respondents were unable to provide such protection (*ibid.*). Pursuant to the instructions of the court of appeals, the district court then evaluated the likelihood of success of respondents' proposed plan of reorganization. The court found that no such likelihood existed, concluding that three facts doomed any chance that respondents would have of successfully reorganizing: respondents had an asset-to-liability ratio of .67 to 1; they had "failed to establish their ability to operate profitably in the future"; and American farmers in general face oppressive economic conditions that are unlikely to improve soon (*id.* at A87).

3. a. The court of appeals reversed the bankruptcy court's order that granted petitioners relief from the automatic stay. The court first held that the bankruptcy court and the district court had analyzed the adequate

protection issue improperly and that petitioners were not entitled to immediate relief from the stay because of a lack of adequate protection (Pet. App. A7-A12).

b. The court then addressed petitioners' argument that the automatic stay must be lifted because of the district court's finding that the respondents' proposed reorganization plan was infeasible. Section 362(d)(2) of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 362(d)(2), requires the bankruptcy court to lift the automatic stay if the debtor has no equity in the property on which the creditor seeks to foreclose and the property "is not necessary to an effective reorganization." All agreed that respondents have no equity in their property, and petitioners argued that, because respondents have no likelihood of achieving a successful reorganization, it follows that none of their property could be "necessary to an effective reorganization." The court of appeals agreed that, if no reorganization was feasible, the stay should be lifted (Pet. App. A15). The court, however, reversed the district court's finding that there was not a reasonable likelihood of a successful reorganization. The court concluded that the district court, in determining the extent to which petitioners' claims were secured, erred in using the valuations that the bankruptcy court had made in ruling on the adequate protection issue. The court held that the extent to which petitioners were secured creditors had to be determined according to the value of the property at the time that the plan would be confirmed (*id.* at A16). The court, in dictum, opined that respondents could indeed propose a feasible reorganization plan (*id.* at A17-A19, A37-A49).[1]

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[1] The court said (Pet. App. A17-A18), "it apears probable that once their secured debt is restructured to reflect present values of land and equipment as Section 506(a) requires, [petitioners] can repay that debt over a reasonable period of time with interest and



The court next rejected petitioners' contention that, because they had legitimate objections to any proposed plan that would allow respondents to retain an interest in the property, the bankruptcy court would be precluded from confirming the plan. Petitioners argued that, because their claims were substantially undersecured, any plan of reorganization would have to treat them as unsecured creditors for this portion of their claims (see 11 U.S.C. 506(a)). They noted that no realistic plan proposed by respondents would provide for full payment of these unsecured claims. Thus, petitioners concluded that any plan that included respondents' participation could not satisfy the absolute priority rule embodied in 11 U.S.C. (& Supp. III) 1129(b) and could not be confirmed over their objections.[2]

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make substantial payments [but without interest] to unsecured creditors." The "feasible reorganization plan," as more fully spelled out in an appendix to the court's opinion (see *id.* at A47), consists in essence of scaling down the secured debt to the value of the collateral, issuing various new secured notes against that portion of the debt, issuing non-interest-bearing unsecured notes for the remainder, payable over a 30-year period, and allowing the debtors to retain the equity.

[2] Section 1129(b) in relevant part provides:

(1) * * * the court * * * shall confirm the plan * * * if the plan does not discriminate unfairly, and is fair and equitable [to impaired, dissenting creditor classes].

(2) * * * [T]he condition that a plan be fair and equitable * * * includes the following requirements—

* * * * *

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

The court of appeals rejected petitioners' interpretation of Section 1129. It interpreted that section as applying a "modified version of the traditional absolute priority rule" (Pet. App. A22), under which a plan proposed by respondents could be confirmed over petitioners' objections so long as respondents retain an interest that does not exceed the value of their future "labor, experience, and expertise" (*id.* at A26). The court cited this Court's decision in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), which it read as allowing a debtor to participate in a reorganization so long as he "contributes to the reorganization enterprise something that is reasonably compensatory and is measurable" (Pet. App. A24). The court then reasoned that respondents' promise to contribute their future labor and their expertise met this requirement, and thus respondents could retain an equity interest in the property equal to the value of those contributions (*id.* at A24-A25).

c. Judge Gibson dissented. He criticized the majority for misinterpreting *Los Angeles Lumber*, which he read as allowing debtor participation in a reorganization only when the debtor contributes cash or makes contributions "distinctly capital in nature" (Pet. App. A34).[3] Judge Gibson argued that, because respondents' labor clearly did not fall within this narrow exception to the absolute priority rule, any proposed plan that allowed them to retain an interest could not be confirmed (*id.* at A34-A35).

4. The court of appeals denied rehearing en banc (Pet. App. A51-A58). Four of the five judges who voted for rehearing en banc joined an opinion that labeled the court's ruling on the absolute priority issue "directly contrary to * * * *Los Angeles Lumber*" (*id.* at A54).

[3] Judge Gibson also dissented on the ground that he, unlike the majority, agreed with both the bankruptcy court and the district court that, because respondents could not provide petitioners with adequate protection, the automatic stay should be lifted (Pet. App. A28-A30).



The other dissenting judge expressed tentative agreement with the panel dissent (*ibid.*).

## SUMMARY OF ARGUMENT

The absolute priority rule, which was originally a judicial gloss on the phrase "fair and equitable" as used in the old Bankruptcy Act, has now been codified in Chapter 11 of the Bankruptcy Code. Under this codification, an impaired, dissenting class of unsecured creditors may block confirmation of a plan of reorganization unless (i) members of the class receive or retain property of a value equal to the allowed amount of their claims or (ii) no junior interests (such as the debtor or equity holders in the debtor) participate in the plan. This rule recognizes that the creditors of an insolvent enterprise are the owners of that enterprise and should receive the benefit if the enterprise succeeds in reorganization. The Code allows unsecured creditors to *consent* to the participation of more junior interests, even though the claims of unsecured creditors have not been fully honored, in recognition of the fact that participation of the more junior interests will sometimes be advantageous to the creditors.

Before passage of the Code, equity holders could in some circumstances participate in a plan of reorganization even *without* the consent of unsecured creditors whose claims were not fully honored. See, *e.g.*, *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 117, 121-122 (1939) (dictum). In other words, before the Code the determination whether junior participation would be advantageous to creditors whose claims were not fully honored was not left entirely to the judgment of those creditors. But the Code does leave that determination to the creditors (voting as a class) and thus has abolished the *Los Angeles Lumber* exception to the absolute priority rule. The Code, for the first time, gives a statutory definition of "fair and equitable" rather than leaving the matter to judicial development, and the ex-

press terms of the Code leave no room for an exception to the absolute priority rule. Rather, any accommodation of equity holders in a plan of reorganization that does not leave each unsecured creditor with property of a value equal to the allowed amount of its claim must come through agreement among the interested parties.

In any event, the exception discussed in *Los Angeles Lumber* is far too narrow to permit equity holders to participate in a plan of reorganization on the basis of a contribution of future "labor, experience, and expertise," over the objection of a class of unsecured creditors whose claims have not been fully honored. The Court in that very case rejected the argument that such "intangibles" as " 'financial standing and influence in the community' [which] can provide a 'continuity of management' " (308 U.S. at 122 (citation omitted)) may constitute the kind of contribution that might permit unconsented-to participation by equity holders when creditor claims have not been fully honored. The Court in *Los Angeles Lumber* likewise rejected the argument, accepted by the court of appeals in this case, that a court may force dissenting creditors who are not receiving "fair and equitable" treatment to accept a plan of reorganization merely because, in the court's view, the plan will preserve the going-concern value of an enterprise. The final argument of the court of appeals—that the absolute priority rule must be abrogated in order to allow farmers to reorganize—is a policy argument that Congress has accepted in recent amendments adding Chapter 12 to the Bankruptcy Code, but it does not justify the result reached in this Chapter 11 case.



## ARGUMENT

### A COURT MAY NOT CONFIRM A PLAN OF REORGANIZATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE WITHOUT THE CONSENT OF A CLASS OF UNSECURED CREDITORS WHOSE CLAIMS ARE IMPAIRED AND WHO DO NOT RECEIVE PROPERTY OF A VALUE EQUAL TO THE ALLOWED AMOUNT OF THEIR CLAIMS, IF THE PLAN ALLOWS JUNIOR INTERESTS TO PARTICIPATE ON THE BASIS OF FUTURE CONTRIBUTIONS OF "LABOR, EXPERIENCE, AND EXPERTISE"

Section 362(d)(2) of the Bankruptcy Code provides for lifting the automatic stay when (1) the debtor has no equity in the property sought to be removed from the stay's protection and (2) that property is not necessary for a successful reorganization. In this case it is undisputed that the first requirement is met. The second requirement is satisfied whenever the debtor fails to show that, with the property the creditor seeks, it is "realistically possible" that the debtor could successfully reorganize. See, *e.g.*, Pet. App. A15; *In re Albany Partners, Ltd.*, 749 F.2d 670, 673 n.7 (11th Cir. 1984); *In re Craghead*, 57 Bankr. 366, 370 (W.D. Mo. 1985). The stay in this case should therefore be lifted if there is no realistic possibility that respondents could successfully reorganize.

A plan of reorganization may be confirmed only if it meets either the terms of 11 U.S.C. (& Supp. III) 1129(a)(8), which permits confirmation when every creditor class either is "not impaired"[4] or accepts the

[4] The term "impaired" is defined, for purposes of the Code, in 11 U.S.C. (& Supp. III) 1124. A claim is "impaired" unless (1) the legal, equitable, and contractual rights to which the claim entitles its holder are unaltered; (2) the plan cures a prior default by specified means and leaves the holder of the claim with the legal, equitable, and contractual rights to which the claim entitled the holder before the event of default; or (3) the holder of the claim receives cash equal to the allowed amount of the claim.

plan, or the terms of 11 U.S.C. (& Supp. III) 1129(b), which in essence allows a plan to be imposed on an impaired, dissenting class if it is "fair and equitable." [5] It is undisputed that respondents could not propose a plan that meets the terms of Section 1129(a)(8), because petitioners will clearly be impaired, and they have, and have said they will assert, legitimate objections to any proposed plan of reorganization (Pet. App. A19). Because of the size of their unsecured claims, their objection would prevent the class of unsecured creditors from assenting to any reorganization plan (see *id.* at A46).[6]

Accordingly, respondents could successfully reorganize only if they could propose a plan that meets the terms of Section 1129(b), which requires that the plan be "fair and equitable." The court of appeals recognized that, in light of respondents' financial condition, "any realistic reorganization plan proposed by [respondents] could not provide the unsecured creditors with property equal to the amount of their allowed claims" (Pet. App. A22). It is also undisputed that respondents have nothing to contribute to a plan of reorganization other than their "labor, experience, and expertise" (*id.* at A26). But a plan of reorganization that allows debtor participation in these circumstances cannot be "fair and equitable" within the meaning of the Bankruptcy Code. Petitioners

[5] Section 1129(b), which allows confirmation of a plan that meets all of the requirements of Section 1129(a) except paragraph (8), is quoted in note 2, *supra*. In addition to meeting the terms of either Section 1129(a)(8) or Section 1129(b), every plan of reorganization must meet the terms of 11 U.S.C. (& Supp. III) 1129(a)(7), which requires that *each* creditor (regardless of the class to which that creditor belongs) either assent to the plan or receive or retain under the plan property at least equal in value to what it would receive or retain if the debtor were liquidated.

[6] A class of creditors is deemed to have accepted a plan of reorganization when two-thirds of the total dollar amount of the claims within that class *and* one-half of the actual number of creditors within that class have agreed to the plan. 11 U.S.C. 1126(c).



are therefore entitled to the lifting of the automatic stay.

### A. Chapter 11 of the Bankruptcy Code Gives an Impaired, Dissenting Class of Unsecured Creditors Absolute Priority over Equity Holders

The Bankruptcy Code delineates the criteria that must be satisfied for a plan to be "fair and equitable." [7] If the impaired, dissenting class is unsecured,[8] a plan is "fair and equitable" as to members of that class only if each member "receive[s] or retain[s] on account of [its] claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim" (11 U.S.C. 1129(b)(2)(B)(i)) or if no junior interests participate in the reorganization (11 U.S.C. (& Supp. III) 1129(b)(2)(B)(ii)). This requirement is the statutory embodiment of what has come to be known as the "absolute priority" rule.

The absolute priority rule plays an important role in bankruptcy proceedings under Chapter 11. When an en-

[7] Under Chapter X of the old Bankruptcy Act of 1898, 11 U.S.C. (1976 ed.) 501 *et seq.*, and its predecessor, Section 77B (added by Act of June 7, 1934, ch. 424, § 1, 48 Stat. 911-922) (repealed 1938), a plan could be confirmed only if it was "fair and equitable." Unlike the present Bankruptcy Code, the old Act did not define "fair and equitable." This Court held that those words were a term of art that required creditors' claims to be fully honored before equity holders could participate in the reorganized enterprise. *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Co.*, 317 U.S. 78, 85 (1942) (construing Chapter X); see also *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) (construing Section 77B). On the other hand, Chapter XI of the old Act, 11 U.S.C. (1976 ed.) 701 *et seq.*, did not require a plan to be "fair and equitable." Instead, it had only to be in the best interests of the creditors. Under this test, a plan could be confirmed so long as the creditors received the liquidation value of their claims. See H.R. Rep. 95-595, 95th Cong., 1st Sess. 223 (1977).

[8] To the extent that FLB's and Norwest's claims exceeded the value of their collateral, they were entitled to be treated as unsecured creditors. 11 U.S.C. 506(a).

terprise files for bankruptcy, it can either be reorganized under Chapter 11 or liquidated under Chapter 7, 11 U.S.C. (& Supp. III) 701 *et seq.*[9] Whether a company should be reorganized or liquidated depends on whether it is worth more as a going concern than if it were liquidated piecemeal. See 11 U.S.C. (& Supp. III) 1129(a)(7) (allowing confirmation of reorganization plan only when each creditor is assured of receiving at least what it would receive in a liquidation, or consents to less favorable treatment). When the company is worth more as a going concern than it would be if it were liquidated, there is a going-concern surplus. The absolute priority rule requires that any such surplus be distributed to the creditors according to the priority of their claims and that the debtor share in the enterprise only after creditors' claims have been fully honored.[10]

The rationale for that rule is that when an enterprise[11] is insolvent, *i.e.*, when its debts exceed the present

[9] Some individual debtors also have the option of proceeding under Chapter 13, 11 U.S.C. (& Supp. III) 1301 *et seq.* Since November 26, 1986, family farmers have had the option of proceeding under a new Chapter 12. See Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 (1986 Act), Pub. L. No. 99-554, § 255, 100 Stat. 3105-3114 (to be codified at 11 U.S.C. 1201 *et seq.*); see also note 29, *infra*.

[10] We use "fully honored" as a shorthand phrase for the statutory requirement that the holder of an unsecured claim "receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim" (11 U.S.C. 1129(b)(2)(B)(i)). The Code, like prior law, does not "require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of [for example] income bonds or preferred stock." *Northern Pacific Ry.* v. *Boyd*, 228 U.S. 482, 508 (1913).

[11] Respondents owned the assets of their farm in their individual capacities rather than as shareholders in a corporation. Chapter 11, however, does not make any relevant distinction between corporate and individual debtors. Although the analogy does not apply in all



value of its assets, all of its assets are properly treated as owned by the creditors. Therefore, when the assets remain in the enterprise and it is reorganized, the reorganized enterprise properly belongs to the creditors. Equity interests, whose claims against the old enterprise had no value because it was insolvent, contribute nothing to the reorganized enterprise. See Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857, 894 (1982) ("Reorganization proceedings provide nothing more than a method by which the sale of an enterprise as a going concern may be made to the creditors themselves."). By leaving their assets in a reorganized enterprise, creditors gamble that there will indeed be a going-concern surplus and that they will ultimately fare better than if the enterprise were liquidated. As Judge Friendly recognized, in this situation "it is hard to see why [the unsecured creditors] should not reap the entire gain if the gamble succeeds, rather than allow the stockholders to have what essentially is a free ride." *SEC* v. *Canandaigua Enterprises Corp.*, 339 F.2d 14, 21 (2d Cir. 1964).[12]

This is not to say that equity holders can never participate in a reorganized enterprise. At times, it may be advantageous to the creditors to allow equity holders to

respects (see note 28, *infra*), it is convenient to think of respondents as the equity owners of a farming enterprise of which petitioners are creditors.

[12] Before he went on the bench, Judge Friendly put the matter more pointedly: "A plan which gives to creditors securities with a market value of less than one hundred cents on the dollar of the creditors' claims and permits stockholders without assessment to retain a substantial share in the enterprise is, in the language of the Supreme Court in [*First National Bank* v. *Flershem*, 290 U.S. 504, 519 (1934)], an attempt to invoke the power of the court 'not to enforce rights of creditors, but to defeat them.' Such a transaction, as pointed out in the opinion of Mr. Justice Brandeis, is simply a fraudulent conveyance." Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 Harv. L. Rev. 39, 77-78 (1934) (footnote omitted).

participate in a plan of reorganization even though creditors' claims have not been fully honored. The participation of current equity holders may sometimes appear necessary to capture the going-concern surplus that is the raison d'être of reorganization. This Court has suggested that this may be the case, for example, when the enterprise lacks the necessary cash to operate and equity holders are the only willing source of such cash. *Kansas City Terminal Ry.* v. *Central Union Trust Co.*, 271 U.S. 445, 455 (1926). But see p. 22, *infra*. Or the equity holders may also be the managers and may have experience, expertise, and management skills that make the enterprise more valuable than it would be without them. In those situations, both creditors and equity holders have an incentive to negotiate an agreement that allows continuing participation by the equity holders. The creditors realize that, if they do not allow the equity holders to participate, they will lose the value that the equity holders would otherwise contribute to the reorganized firm. The equity holders, on the other hand, realize that, if they do not engage in good-faith bargaining, they will walk away with nothing.

Chapter 11 permits the creditor classes to agree to equity-holder participation, even though creditors' claims are not fully honored, when the *creditors*, voting as classes, believe that their best interests would be served. Rather than require *every* plan of reorganization to be fair and equitable (as old Chapter X did), Chapter 11 provides that a class of creditors may consent to a plan under which its members' claims are not fully honored and junior claimants nevertheless participate (11 U.S.C. 1129(a)(8)(A)).[13] The express purpose of this is to pro-

[13] Under Chapter X and its predecessor, Section 77B, a plan that was not fair and equitable could not be confirmed even if it had the requisite approval of all classes of creditors. See Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 Case W. Res. L. Rev. 301, 325-326 (1982) (discussing this change between pre- and post-Code law). For example, in *Case* v. *Los Angeles Lumber*



vide a mechanism whereby the parties in interest can reach a mutually beneficial agreement as determined by the requisite vote of each class. See H.R. Rep. 95-595, 95th Cong., 1st Sess. 224 (1977) ("[N]egotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. * * * Only when the parties are unable to agree on a proper distribution of the value of the company does the [Bankruptcy Code] establish a financial standard."); Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651, 653 (1974) ("The absolute priority doctrine can be characterized as a way of structuring negotiations so that they are sufficiently disciplined to be held within permissible areas and to permit judicial review.").

It is against this background and statutory structure that respondents' attempt to include themselves in a plan of reorganization, despite a conceded inability to honor fully the claims of an impaired, dissenting class of unsecured creditors, must be tested. Although the secured debt substantially exceeded the value of petitioners' collateral, the court of appeals concluded that a plan would be feasible if it provided for a scaling down of the secured claims to the present value of the collateral, with new secured notes to be awarded against the scaled-down secured claims, and long-term unsecured notes (bearing no interest) to be awarded against the balance.[14] The

*Products Co.*, 308 U.S. 106 (1939) (applying Section 77B), the plan of reorganization was denied confirmation as not fair and equitable, notwithstanding bondholder consent that would be sufficient under the Code to confirm the plan under Section 1129(a)(8)(A) without reaching the question of fairness and equity under Section 1129(b). See 308 U.S. at 114-115.

[14] The court of appeals seems to have believed (see Pet. App. A47) that giving the secured creditors new secured notes equal in face amount to the present market value of their collateral, plus an unsecured (and non-interest-bearing) note for the balance of their debt, would necessarily leave them as well off as or better off than

court of appeals then ruled that such a plan could be imposed on a nonassenting class of unsecured creditors because it would be "fair and equitable": it would not violate the requirement of Section 1129(b)(2)(B) that, unless unsecured creditors receive property of a value equal to their claims, junior interests may receive nothing. The court of appeals reached that conclusion because, it said, there is an uncodified exception to that rule when the junior interests make a contribution in "money or money's worth," and contributions of "labor, experience, and expertise" satisfy that requirement. We submit that both conclusions are wrong: no such exception to the creditors' entitlement to "absolute priority" is permitted by the Bankruptcy Code, and the contribution suggested by the court of appeals would not have satisfied the requirements of pre-Code cases.

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liquidation. That is, of course, exactly the fallacy that the absolute priority rule was designed to combat. The present value of any income-producing property is a weighted average of the range of possible future values. Giving the creditor a secured (nonrecourse) note in an amount equal to the present value of the property gives it only the *bottom portion* of the range, which is necessarily worth less (frequently—and apparently here—much less) than the property itself or the proceeds of a present sale. An unsecured note of the kind envisioned here will not make up the difference: it will not give the creditor the equivalent of ownership. That is why Section 1129(b)(2)(A) requires that dissenting secured creditors receive *payments* with a present value equal to the value of their collateral and Section 1129(b)(2)(B) requires that dissenting unsecured creditors receive *property of a value* equal to their claims before junior interests may receive anything.



### B. There Is No Exception to the Absolute Priority Rule That Allows Equity Holders to Participate in a Plan of Reorganization Under Chapter 11, over the Objection of a Dissenting, Impaired Class of Creditors Whose Claims Have Not Been Fully Honored, on the Basis of a Contribution of Future "Labor, Experience, and Expertise"

#### 1. *Chapter 11 of the Bankruptcy Code does not contain an exception to the absolute priority rule for equity holders who contribute to the reorganized enterprise*

Before the passage in 1978 of the Bankruptcy Code, 11 U.S.C. (& Supp. III) 101 *et seq.*, there were circumstances in which an equity holder could participate in a reorganized enterprise even though the claims of the creditors of the enterprise were not fully honored and those creditors did not consent to such participation. See, *e.g.*, *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 117, 121-122 (1939) (dictum). The court of appeals assumed, without ever explaining where its rule of law could be found in the Bankruptcy Code, that such participation is still possible. It then went on to hold—erroneously (see pp. 23-30, *infra*)—that the necessary conditions for shareholder participation were met in this case. We submit, however, that the court's first error was its failure to recognize that the Code has changed prior law and that, under Chapter 11 of the Code, equity owners can never participate in a reorganized enterprise over the dissent of a class of creditors whose claims are impaired and who do not receive or retain property of a value equal to the allowed amount of their claims.[15]

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[15] The lower courts appear to be divided on this question. Two other courts of appeals and some bankruptcy courts have agreed with the implicit conclusion of the court below. See *In re U.S. Truck Co.*, 800 F.2d 581, 587-588 (6th Cir. 1986) (allowing stockholder to participate in plan of reorganization based on new payment of $100,000); *In re Potter Material Serv., Inc.*, 781 F.2d 99, 101 (7th Cir. 1986); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454, 456 & n.1 (Bankr. C.D. Ill. 1987); *In re Landau Boat Co.*, 13 Bankr. 788, 792-793 (Bankr. W.D. Mo. 1981); *In re Marston Enterprises,*

a. The opinion of Justice Douglas for a unanimous Court in *Case* v. *Los Angeles Lumber Products Co.*, *supra*, strongly reaffirmed the principle that " 'creditors are entitled to priority over stockholders against all the property of an insolvent corporation.' " 308 U.S. at 116 (quoting *Kansas City Terminal Ry.* v. *Central Union Trust Co.*, 271 U.S. 445, 455 (1926)). The Court in *Los Angeles Lumber* reviewed a plan of reorganization, which had been approved by the lower courts, that allowed stockholders to participate in the reorganized company, although the claims of bondholders were not to be fully honored. The bankruptcy court had found, and the court of appeals had affirmed, that participation would "be an asset of value" to the new corporation "because of the familiarity of these stockholders with the business * * * and because of their financial standing and influence in the community." *In re Los Angeles Lumber Products Co.*, 100 F.2d 963, 965 (9th Cir. 1939). The lower courts concluded that these findings allowed the plan to be confirmed despite the objection of certain bondholders.[16] This Court, while not disagreeing with the factual findings of the lower courts, held that the old stockholders did not

13 Bankr. 514, 518 (Bankr. E.D.N.Y. 1981). Some bankruptcy courts have implied, if not held, that it is no longer possible for equity holders to retain ownership over the objection of a class of creditors whose claims are not fully honored. See *In re Pine Lake Village Apartment Co.*, 19 Bankr. 819, 834 (Bankr. S.D.N.Y. 1982) (holding plan that included retained ownership by partners unconfirmable even though partners proposed to contribute $700,000 in cash); *In re Pecht*, 57 Bankr. 137 (Bankr. E.D. Va. 1986). Although, as we argue below, the judgment of the court of appeals is plainly wrong under the *Los Angeles Lumber* dictum and other pre-Code cases, we also believe that the Bankruptcy Code has superseded those cases in this regard.

[16] A substantial majority of the bondholders had voted to accept the plan (308 U.S. at 111-112, 115). Under the Bankruptcy Code, this assent would have been sufficient to permit confirmation of the plan (as far as this class was concerned) notwithstanding the departure from "fairness and equity." See 11 U.S.C. (& Supp. III) 1125.



contribute anything to the plan that would allow the old stockholders to retain an interest in the company.

The Court noted that the reorganization statute required a plan to be "fair and equitable."[17] This term had been interpreted to mean that " 'any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.' " 308 U.S. at 116 (quoting *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry.*, 174 U.S. 674, 684 (1899)). Under this test, the Court held that the plan offered by the shareholders should not have been confirmed (308 U.S. at 122-132).

Despite its holding that the plan could not be confirmed, the Court suggested that there were limited circumstances in which a plan should be confirmed even though shareholders participated and creditors' claims were not fully honored. The Court "stress[ed] the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders" (308 U.S. at 121 (footnote omitted) (quoting *Kansas City Terminal Ry.* v. *Central Union Trust Co.*, 271 U.S. at 455)). "Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made" (308 U.S. at 121). The Court thus stated that there was an exception to the judicially developed absolute priority rule—specifically, that it might confirm a plan over the objection of a creditor whose claim was not fully honored if "the stockholder's participation [was] based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder" (*id.* at 122). It is the exception to the absolute priority rule, as stated in this last passage, on which the court of appeals in this

[17] Unlike the present Bankruptcy Code, neither Section 77B (which was applied in *Los Angeles Lumber*) nor Chapter X (which replaced Section 77B in 1938) defined this term. See note 7, *supra*.

case relied (Pet. App. A23-A24). Although that reliance was misplaced in light of the *holding* of *Los Angeles Lumber* (see pp. 23-28, *infra*), we also submit that these dicta from *Los Angeles Lumber* do not accurately state the law under the Bankruptcy Code.

b. The Bankruptcy Code modified the law governing confirmation of plans of reorganization in two relevant respects. First, whereas Chapter X of the old Bankruptcy Act provided that a plan had to be "fair and equitable" (11 U.S.C. (1976 ed.) 621(2)) but did not define that term, the Bankruptcy Code provides an elaborate definition. Second, as previously noted, the Bankruptcy Code permits a creditor class, by a class vote that overrides the objections of minority members, to assent to a plan that is *not* "fair and equitable." Together, these two changes leave no room to allow an equity holder to buy his way into the reorganized company over the objections of an impaired class of creditors who do not receive or retain property of a value equal to the allowed amount of their claims.

The Bankruptcy Code has replaced the judicially developed "fair and equitable" test of the old Bankruptcy Act with a statutorily prescribed one. The Code provides that a plan is fair and equitable, with respect to an impaired, dissenting class of unsecured creditors, in two—and only two—circumstances (11 U.S.C. (& Supp III) 1129(b)(2)(B)):

> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

Even when equity holders make new capital contributions as part of the plan, the interest that they "receive or retain under the plan" is received or retained on



account of their pre-petition claim or interest in property of the estate.[18] It is therefore forbidden by the express terms of Section 1129(b)(2)(B) unless all unsecured creditors in the dissenting class receive "property of a value, as of the effective date of the plan, equal to the allowed amount of [their] claim[s]." The language of the Code admits of no other conclusion.

Nothing in the legislative history suggests a congressional intention to maintain the exception discussed in *Los Angeles Lumber*. The House report, in describing proposed Section 1129(b), states: "The general principle of the subsection permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan." H.R. Rep. 95-595, *supra*, at 413.[19] No exceptions to this rule seem to be contemplated.[20]

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[18] That is clear because there is no provision of the Bankruptcy Code that could even conceivably be read to allow, over the objection of a class of creditors, the participation in a plan of a person or entity that contributed new capital but had *no* prior claim or interest in any property of the estate. Any rule that allowed equity holders, over the objection of a class of creditors, to participate in the plan by contributing new capital would thus necessarily create a special rule for them on account of their prior claim or interest in property of the estate.

[19] The Bankruptcy Commission, the congressionally appointed committee charged with evaluating the need for bankruptcy reform, had suggested to Congress that the absolute priority rule be abandoned. The Commission had urged that the result in *Los Angeles Lumber* be statutorily overturned, and that junior classes be allowed to participate to the extent that they contribute anything of value to the reorganization. This proposal was criticized in the academic literature. See, *e.g.*, Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 Am. Bankr. L.J. 305 (1974); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 Harv. L. Rev. 1786 (1974). As is apparent from the Bankruptcy Code, it was flatly rejected by Congress.

[20] Indeed, even if the legislative history were altogether silent on the subject, the language of the statute would be a sufficient indi-

It is not surprising that the Code has dropped the infusion-of-new-capital exception to the absolute priority rule. The exception reflected two conditions that have since changed. First, the Court believed in 1939 (and earlier) that new capital to fund a reorganization *beneficial to creditors* might be available only from old equity holders. See *Los Angeles Lumber*, 308 U.S. at 117; *Kansas City Terminal Ry.*, 271 U.S. at 455. In today's capital markets, which make it far easier for worthwhile ventures to obtain financing, that is a much less realistic concern. See Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651, 672 (1974). Indeed, the inability of a reorganized company to convince anyone other than a pre-petition equity holder to lend it money today suggests not a failure of the capital markets as much as a realistic assessment that the reorganization is not likely to succeed.

Second, the underlying philosophy of the Code is to allow classes of of creditors to determine what is in their own best interest. See pp. 14-15, *supra*. When a class of creditors dissents from a proposed plan that provides for equity-holder participation, that indicates that the necessary percentages of the class do not believe that the equity holders' participation in a reorganization would increase the value of their claims. The Bankruptcy Code leaves that decision to the creditors,[21] and there is no longer any need for a court to decide whether, in a particular case, continuing participation by equity holders might be in their best interests. The creditors own the assets, it is their money that is at stake, and they are

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cation that prior law had been changed. "It would be extraordinary to require legislative history to *confirm* the plain meaning of [Section 1129(b)(2)(B)]." *Bourjaily* v. *United States*, No. 85-6725 (June 23, 1987), slip op. 6.

[21] See Blum, *The "Fair and Equitable" Standard for Confirming Reorganizations Under the New Bankruptcy Code*, 54 Am. Bankr. L.J. 165, 172 (1980) ("The main protection theme in reorganizations under the new Bankruptcy Code is that adequately informed classes of creditors and shareholders can look after their own interests in the processes of negotiating plans.").



in the best position to ascertain whether a reorganization including the former equity owners would be to their advantage. Were such owners allowed to participate in a reorganization over creditors' objections, the negotiations envisioned by the absolute priority rule would be altered. Creditors, instead of deciding whether a reorganized company would be worth more with equity holders participating, would instead have to consider whether they should reach a compromise with the equity holders to avoid having a bankruptcy judge decide whether the equity holders should participate.[22]

Thus, although we will show in the next section that the judgment of the court of appeals conflicts with pre-Code law, there is a more fundamental reason to reverse that judgment. The exception to the absolute priority rule on which the court of appeals relied does not exist under the Bankruptcy Code.

### 2. *Even if the Bankruptcy Code should be read to contain an exception to the absolute priority rule for equity holders who contribute money or money's worth to the reorganized enterprise, respondents' "labor, experience, and expertise" is not such a contribution*

Whatever basis there may be for assuming that the Bankruptcy Code carries forward the exception to the absolute priority rule enunciated in dicta in *Los Angeles Lumber*—and we see none—there is no basis whatever for any contention that the Bankruptcy Code *expands* that exception beyond the bounds contemplated in *Los*

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[22] The idea that creditors, rather than a judge, can best make the determination whether shareholder participation is beneficial to the creditors is not new. See Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 Harv. L. Rev. 39, 75 (1934) (footnote omitted) (quoting *In re English, Scottish & Australian Chartered Bank*, [1893] 3 Ch. 385, 409) ("As said by Lord Justice Lindley in the *Australian Chartered Bank* case: 'If the creditors are acting on sufficient information and with time to consider what they are about, and are acting honestly, they are, I apprehend, much better judges of what is to their commercial advantage than the Court can be.'").

*Angeles Lumber*. Because respondents' proposed contribution of "labor, experience, and expertise" (Pet. App. A26) is exactly the kind of contribution that the *Los Angeles Lumber* Court held would not suffice to overcome the absolute priority rule, the judgment of the court of appeals should be reversed.

When it noted the existence of an exception to the absolute priority rule, the Court in *Los Angeles Lumber* made it clear that equity-holder participation is permissible only when it is *necessary* to preserve going-concern value *and* the interests of the creditors are protected. The Court said that such particpation is permissible only if the old stockholders are the only available source of capital to keep the reorganized corporation operating (308 U.S. at 117, 121). Even then, the Court was concerned that "the creditor's rights [not] be easily diluted by inadequate contributions by stockholders" (*id.* at 122).[23] Thus, the Court stated (*ibid.*):

> In view of these considerations we believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.[24]

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[23] See also *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510, 530 n.27 (1941) (Douglas, J.).

[24] The court of appeals based its interpretation on the phrase "money's worth" in this passage. It is clear, however, that the full import of this passage is to limit equity owner participation to cases in which the equity owner has infused the debtor with fresh capital, such as cash or marketable property. See also 308 U.S. at 117 ("necessity at times of permitting the inclusion of stockholders on payment of contributions"); *id.* at 121 (emphasis added) ("necessity * * * of seeking *new money*"); *id.* at 121 n.15 (emphasis added) ("This *new money* was commonly necessary in equity reorganizations not only to *provide new working capital* but also to *pay* dissenting creditors."); *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510, 529 n.27 (1941) (emphasis added) ("it should have been shown that there was a necessity of seeking *new money* from [old common stockholders] and that the participation accorded them was not more than reasonably equivalent to their contributions"). Indeed, before *Los Angeles Lumber* the Court had already made it clear in *Kansas City Terminal Ry.* v. *Central Union Trust Co.*, *supra*, that only contribution of "addditional funds * * * essential to the success of the undertaking" would allow shareholders to overcome the absolute priority rule. 271 U.S. at 455; see Friendly, *supra*, 48 Harv. L. Rev. at 76-77. *Los Angeles Lumber* did not purport to alter that rule.



The Court illustrated the narrowness of this exception by refusing to apply it to the facts of *Los Angeles Lumber*. The former shareholders argued that their participation in the new corporation was appropriate even though not all of the creditors' claims were fully honored, on the ground, among others, that they were contributing their financial standing in the business community. The Court held that such "intangibles" simply could not be used to overcome the dictates of the absolute priority rule. "They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities." 308 U.S. at 122-123.

The Court in *Los Angeles Lumber* was clear: either the shareholders contribute new capital that is necessary to the reorganization of the insolvent enterprise, or they do not participate in the reorganization. No court of appeals other than the court below has suggested that an equity holder can participate in the reorganization of an insolvent debtor even though he does not contribute necessary capital to the reorganization. See, *e.g.*, *In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986) ("If [the debtor] were retaining an interest without contributing any capital, the plan would clearly violate the Code."); *In re Potter Material Serv., Inc.*, 781 F.2d 99, 101 (7th Cir. 1986) ("An equity-interest owner may retain an interest in the debtor corporation so long as the owner invests new capital into the corporation."); *In re Muskegon Motor Specialties*, 366 F.2d 522, 525 (6th Cir. 1966); *Highland Towers Co.* v. *Bondholders' Protective Comm.*, 115 F.2d 58, 60 (6th Cir. 1940); *Metropolitan Holding Co.* v. *Weadock*, 113 F.2d 207, 209 (6th Cir. 1940); see also *Price* v. *Spokane Silver & Lead Co.*, 97

F.2d 237, 245 (8th Cir. 1938). The decision of the court of appeals constitutes a marked departure from this accepted teaching.[25]

The court of appeals sanctioned participation of junior interests so long as they contribute "something that is reasonably compensatory and is measurable" (Pet. App. A24). Thus, the court expanded permissible contributions

[25] See also *In re Baugh*, 73 Bankr. 414, 418 (Bankr. E.D. Ark. 1987) ("The *Ahlers* decision radically expanded the exception to the absolute priority rule * * *."); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454, 456-457 (Bankr. C.D. Ill. 1987) (declining to follow decision below); *In re C & P Gray Farms, Inc.*, 70 Bankr. 704, 710 n.21 (Bankr. W.D. Mo. 1987) (emphasis added) ("[T]he universally occur[r]ing * * * doctrine of 'sweat equity' * * * is so artificial and inappropriate that it can exist only where the debtor's operations are in reality so unpromising that an honest and conscientious court would be obliged to find the plan infeasible. The court in the *Ahlers* case is to be admired for groping for some device, *however unsound*, which will ameliorate the desperate plight of the American farmer."); *In re Big Dry Angus Ranch, Inc.*, 69 Bankr. 695, 698 n.3, 700 n.6 (Bankr. D. Mont. 1987) (decision below was designed to "circumvent" the absolute priority rule and to say that "the absolute priority rule means something different than intended by 1129(b)"); *In re Stegall*, 64 Bankr. 296, 300 (Bankr. C.D. Ill. 1983) ("the solution proposed by the *Ahlers* majority is contrary to the Bankruptcy Code and a long line of case law"); Koger & Acconcia, *In re Ahlers: Capitalizing on Sweat*, 42 J. Mo. B. 455, 458 (1986) (footnotes omitted) ("Case law has developed a narrow exception to the absolute priority rule * * *. As Judge Gibson pointed out in his dissent, this exception has never been extended to contributions of labor. In fact, previous attempts to qualify non-capital equity in the absolute priority context have been unanimously rejected."); C. Fortgang & T. Mayer, *1986 Interest and Costs for the Secured Creditor in Bankruptcy* 2 (1986) (paper presented to 1986 New York University Workshop on Corporate Reorganization) ("the Eighth Circuit has rejected 45 years of learning on the rights of a dissenting creditor class by ruling that pre-petition equity holders may retain their equity merely by continuing to work"); *id.* at 110-116; Note, In re Ahlers: *The Farm Reorganization Exception to the Absolute Priority Rule*, 32 S.D.L. Rev. 167, 179 (1987) ("The Eighth Circuit's decision in *Ahlers* diverges significantly from the statutory absolute priority rule enacted in the Bankruptcy Code and from the Supreme Court's interpretation of the absolute priority rule in *Los Angeles Lumber*.").



to embrace any promise that has a determinate value.[26] The court found such value in respondents' promise to contribute their future labor and their expertise to the reorganized company. The first contribution certainly is not a capital contribution as envisioned by *Los Angeles Lumber*. Similarly, respondents' farming expertise is not a contribution of capital. Indeed, the Court in *Los Angeles Lumber* expressly disapproved allowing an equity holder to participate in a reorganized company based on such a contribution. See 308 U.S. at 112-113 (citation omitted) (disapproving treatment of " '[equity holders'] familiarity with the operation' of the business and their 'financial standing and influence in the community' [and] * * * 'continuity of management' " as "consideration" for equity-holder participation in the plan of reorganization); *id.* at 123 n.16 (approving court of appeals decision not allowing participation based on supposed management skills).

The court of appeals opined that respondents should be allowed to participate in a reorganization because their participation would preserve the farm's going-concern value (Pet. App. A24-A25). That justification, however, was rejected by the Court in *Los Angeles Lumber*. See 308 U.S. at 123 (citation omitted) ("fact that [creditors] might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan [has] no relevant bearing on whether a proposed plan is 'fair and equitable' ").[27] It is also thoroughly incon-

[26] The court also ignored the requirement of *Los Angeles Lumber* that the equity holder's contribution be necessary to a successful reorganization. See 308 U.S. at 121. There is nothing in the record that suggests, contrary to common sense, that it is necessary to have respondents, as opposed to someone else, operate the farm properties in question.

[27] Likewise, in *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 454 (1940), the Court noted that a difference between Chapter X cases, in which the absolute priority rule applied, and Chapter XI cases, in which it did not, was that in the latter "the preservation of going-concern value through [subordinate creditors' or stockholders'] continued management of the business

sistent with the principle that the creditors themselves, rather than a court, are in the best position to determine whether they will fare better under a plan of reorganization than they would through exercise of their state-law foreclosure rights or through liquidation. See pp. 14-15, *supra*.

The reason for requiring any *Los Angeles Lumber* contribution to be in money or marketable property is, of course, that without that limitation the "reorganization" becomes simply a forced scaling down of the creditors' rights, after which creditors and debtor continue as before—which is transparently what the court of appeals sanctioned here. The equity-holder contributions contemplated by *Los Angeles Lumber* place immediate additional value in the enterprise, where it is subject to the superior claims of creditors, immediately improving their chances of ultimately being paid. In the present case, apart from the question just how much assurance can be taken from the debtors' (unenforceable) promise to work for many years for the reorganized enterprise,[28] if the debtors go into default on their new secured debt three months after reorganization, their "yearly contri-

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may compensate for reduction of the claims of the prior creditors without alteration of the management's interests, which would otherwise be required by" *Northern Pacific Ry.* v. *Boyd*, 228 U.S. 482 (1913).

[28] *Los Angeles Lumber* was of course a *corporate* reorganization, in which the Court could meaningfully speak of "the old stockholders mak[ing] a fresh contribution [from their separate assets] and receiv[ing] in return a participation reasonably equivalent to their contribution" (308 U.S. at 121). The very concept is not easy to apply to the Chapter 11 plan of an individual debtor. Since he *is* the debtor, he *cannot* have any means of making a "fresh contribution" in cash or property. His promise of unsalaried future labor is, as Judge Gibson noted in dissent (Pet. App. A35), not specifically enforceable. And even if permissible indirect means of enforcement would suffice to satisfy the rights of the creditor, it is fundamental to American bankruptcy law that an individual debtor may not be compelled to indenture himself to work off a debt; at least some of the same considerations suggest that he should not be permitted to do so either.



butions of labor, experience, and expertise" (Pet. App. A26) will not have contributed any significant value that is available to meet creditors' claims. The creditors, having been forced to give up substantial rights against the promise that the debtors will farm their land more successfully in the future than in the immediate past, will be back in bankruptcy court with substantially reduced legal claims. Nothing in old Chapter X, present Chapter 11, or *Los Angeles Lumber* permits a court to force them to take that risk.

The court of appeals attempted to justify its result on the ground that "[a]ny other view would deny to most farmers the opportunity to take advantage of the reorganization provisions of the Bankruptcy Act" (Pet. App. A25). That is simply to assert (whether or not correctly) that "most farmers" in straitened circumstances need a partial forgiveness of debt, abrogating the absolute priority rule; and indeed abrogation of the absolute priority rule is the means Congress has chosen in Chapter 12 to respond to farmers' plight. See 100 Stat. 3111 (to be codified at 11 U.S.C. 1225(b)); 132 Cong. Rec. S5556 (daily ed. May 7, 1986) (statement of Sen. Grassley). But this is a Chapter 11 case.[29] Congress in enacting Chapter 11 rejected a suggestion that it do away with the absolute priority rule (see note 19, *supra*). The manifest sympathy that the court of appeals had for farmers may be understandable (although the wisdom of making it harder for farmers to enter into enforceable contracts of indebtedness may be questionable),

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[29] This case does not arise under Chapter 12, and it is unlikely that respondents could convert this proceeding into one under Chapter 12. That new provision appears on its face not to apply to proceedings begun before the effective date of the Act. 1986 Act § 302(a) and (c), 100 Stat. 3119. But see *In re Big Dry Angus Ranch, Inc.*, 69 Bankr. 695 (Bankr. D. Mont. 1987) (allowing conversion of pending Chapter 11 case to Chapter 12); *In re Erickson Partnership*, 68 Bankr. 819 (Bankr. D.S.D. 1987) (same).

but the court did not have the power to rewrite Chapter 11.[30]

The holding of the court of appeals is in irreconcilable conflict with both the Bankruptcy Code and this Court's decision in *Los Angeles Lumber*. It should be reversed.

## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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[30] Commentators have observed about this case: "Hopefully the case can be limited to its facts—a farmer relief measure which is no more than premature judicial enactment of the new chapter 12 * * *. Unfortunately, *Ahlers* purports to apply the absolute priority rule. No principle of jurisprudence prevents *corporate debtors* from using precedents in farm Chapter 11s. In a corporate chapter 11, *Ahlers* would entrench management shareholders at the expense of unsecured creditors." C. Fortgang & T. Mayer, *1986 Interest and Costs for the Secured Creditor in Bankruptcy* 116 (1986) (paper presented to 1986 New York University Workshop on Corporate Reorganization).

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# AMICUS CURIAE

# BRIEF

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No. 86-958

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1987

NORWEST BANK WORTHINGTON AND
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,
*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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## QUESTION PRESENTED FOR REVIEW

Do the absolute priority provisions of Section 1129 of the Bankruptcy Code (11 U.S.C. § 1129) and this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), prohibit confirmation of a debtor's proposed reorganization plan where (i) the senior interests of unsecured creditors will not be paid in full; (ii) the debtor will retain ownership of property; and (iii) the debtor's only contribution to the plan of reorganization is its non-cash promise to provide future labor, experience and expertise?

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**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

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## BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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The American Bankers Association respectfully submits this brief as amicus curiae with the consent of the parties to urge the Court to reverse a decision of a panel of the Eighth Circuit. The court, in that decision, directed the confirmation of a debtor's reorganization plan, even though that plan would violate the "absolute priority" rule of the Bankruptcy Code. In reaching this conclusion, the Eighth Circuit panel majority placed itself at odds with the plain meaning of the statute, a prior decision by this Court, and numerous decisions of lower courts. In addition, it

has created an irreconcilable conflict between preexisting bankruptcy law (as construed by the court) and the Family Farmer Bankruptcy Act, enacted subsequent to the court's decision.

## INTEREST OF THE AMICUS CURIAE

The American Bankers Association is the principal trade association of the commercial banking industry in the United States. Member banks of the Association are located in each of the fifty states and the District of Columbia, and ABA members hold approximately 95% of the domestic assets of the United States commercial banking industry. The Association appears frequently in litigation, either as a party or as amicus curiae, in order to represent the interests of the industry in cases of particular importance. This is such a case.

Nearly four thousand commercial banks in the United States are classified as "agricultural banks"--defined as banks with at least twenty-five percent of their lending dedicated to the financing of farms or ranches.[1] The agricultural sector of the nation's economy has experienced serious dislocations over the past several years. Prices for farmland have just now begin to stabilize after what the Wall Street Journal describes as a "six-year free-fall."[2] When the value of collateral declines precipitously, even those lenders who have taken what at the time appeared to be an

[1] Federal Deposit Insurance Corporation, *Farm Bank Problems and Related Policy Options* at 8-9 (1986).

[2] Kilman, *Number of Imperiled Farm Banks Is Flat But Lenders Don't See Sign of Recovery*, Wall St. J., July 28, 1987, at 7.



adequate security interest in the collateral can find themselves undersecured.

Lack of adequate security, or the means to enforce security interests, seriously imperils lending institutions. In 1986, 138 commercial banks failed in the United States, the highest number since the Great Depression. Of these, fifty-nine were agricultural banks.[3] So far this year, 102 banks have failed,[4] thirty-two of which were agricultural banks, and, through March 31 of this year, an additional 184 agricultural banks had "problem loans" exceeding their capital.[5]

The bankruptcy laws have the twin goals of protecting debtors and of assuring an equitable distribution of the debtor's assets among creditors, preventing preferences, defeating efforts to secrete property and providing remedies against every act by which a failing debtor seeks an unequal distribution. *Merchants' National Bank v. Sexton*, 228 U.S. 634 (1913). In addition, there is a strong public policy in favor of preserving the safety and soundness of the commercial banking system. *Gunter v. Hutcheson*, 674 F.2d 862, 870 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982).

In the case below, the 2-1 panel majority of the Eighth Circuit leaned too far in the direction of furthering what is admittedly the important policy goal of protecting debtors and giving them an opportunity

[3] *FDIC Insured Banks That Have Failed or Been Rescued in 1986*, American Banker, Jan. 6, 1987, at 14 col. 1.

[4] *Bank Failures Climb to 102*, American Banker, July 19, 1987, at 3.

[5] Kilman, *supra*, note 2.

to reorganize their affairs. The decision is in derogation of the other, at least equally important, policy goals, because it makes it even more difficult for lenders to enforce *their* legitimate interests in a manner crucial to *their* viability as lenders to their communities. That is a matter of interest and concern to the banking industry at large.

## SUMMARY OF THE ARGUMENT

In this brief, the amicus curiae, American Bankers Association, will show that the decision of a panel of the Eighth Circuit in the case below fails to conform to the precise language of Section 1129 of the Bankruptcy Code, and that there is no warrant in the legislative history of that section to deviate from the plain language of the statute. Section 1129 is a codification of the "absolute priority" rule as that rule was explained by this Court nearly a half-century ago. On that basis alone, the decision of the court below should be reversed. In addition to that, however, legislation enacted subsequent to the decision of the court below creates an unusual situation in which the Congress has manifestly acted upon certain assumptions about the then-existing state of the law which differ wildly from the assumptions about the same state of the law upon which the Eighth Circuit acted. Unless Congress's assumptions are deemed to be correct, the new legislation not only makes no substantive sense, but it will also be in irreconcilable conflict with the preexisting law--a result which ought not be countenanced by this Court.

## ARGUMENT

The Respondents in this case are farmers in Minnesota who, at the time of their filing of a Chapter



11 reorganization case, owed almost $1 million to the Petitioners, Norwest Bank Worthington and the Federal Land Bank of St. Paul. The Petitioners held security interests in the farmland itself, and in machinery, equipment, crops, livestock and other collateral, but, even so, the Petitioners were undersecured. The Bankruptcy Court so found. *In Re Ahlers*, BKY 3-84-2205, Order dated March 15, 1985 (Bankr. D. Minn.) (Reprinted in Appendix to Joint Petition for Writ of Certiorari A-59, A-62, A-66).

The filing of a Chapter 11 case entitles a debtor to an automatic stay of proceedings to collect debts, 11 U.S.C. § 362(a), while a plan for reorganization is proposed and the feasibility of it is determined. 11 U.S.C. §§ 1121-1129. Here, the Eighth Circuit panel has held that a plan which permitted the Respondents to retain an equity interest in the property could be feasible and could be approved, even over objection by unsecured creditors, and even though the interests of those unsecured creditors could not be provided for in full. *In Re Ahlers*, 794 F.2d 388, 401 (8th Cir. 1986). The equity interest to be retained by Respondents would have been measured by the future value of their labor, experience and expertise (*Id.* at 403).

There does not seem to be any question that any such interests of the debtors in the property would be junior to the claims of the unsecured creditors. And yet, 11 U.S.C. Section 1129(b)(2)(B)(ii) specifically provides that a reorganization plan which does not provide in full for the unsecured creditors' interests cannot be approved unless "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account

of such junior claim or interest *any* property." (Emphasis supplied.) Ordinarily, that should be the end of the inquiry, for this Court has directed that unambiguous language in a statute must be given effect. *Board of Governors of the Federal Reserve System v. Dimension Financial Corporation*, 106 S. Ct. 681 (1986).

Nevertheless, this Court has recognized an exception to the traditional "absolute priority" rule. In *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), the Court allowed that a debtor who injects fresh capital into the endeavor could participate in a reorganization plan to the extent of that contribution. However, it is clear that the Court intended that as a very narrow deviation from the ordinary rule. It specifically rejected consideration of "a host of intangibles which . . . would serve as easy evasions of the principle of full or absolute priority." 308 U.S. at 122. The labor, experience and expertise to be contributed by the debtors in this case, in the words of the *Case* court, "reflect merely vague hopes or possibilities." 308 U.S. at 123.

The absolute priority rule, as understood and construed by the Supreme Court in 1939, is the same rule enacted in the comprehensive revisions of the bankruptcy laws in 1978.

In 1970, Congress created the Commission on Bankruptcy Laws of the United States, Pub. L. No. 91-354, and charged it with studying the existing system and proposing any necessary changes to it. Among other things, the Commission specifically evaluated the judicially created absolute priority rule. When it made its report to Congress in 1973, it recommended that that rule be *modified* "by allowing



stockholders to participate (in a reorganization plan) if their future contribution, i.e., continued management, is essential to the business." Report of the Commission of the Bankruptcy Laws of the United States, H. R. Doc. No. 137, 93rd Cong. at 254-259 (1973). The Commission's draft of legislation designed to relax the absolute priority rule contained a Section 7-303 which, according to the explanatory notes, "allows the court to confirm, where the plan allows participation by ownership not permissible under the absolute priority test, if the participation is supported by *e.g.*, continued management; this adopts the District Court's opinion which was reversed in *Case v. Los Angeles Lumber Products Co.*" *Id.* at 254.

Congress rejected this particular recommendation of the Bankruptcy Commission. In its Report, the House of Representatives Committee clearly expressed its intent that the bill would adhere to the existing absolute priority rule in all respects relevant to this case:

> [T]he bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all. The rule is a partial application of the absolute priority rule now applied under Chapter X and requires a full valuation of the debtor as the absolute priority rule does under current law. The important difference is that the bill permits senior classes to take less than full payment in order to expedite or insure the success of reorganization.

H. R. Rep. No. 595, 95th Cong., 1st Sess. at 224 (1978).

> The general principle of the subsection permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. A dissenting class must be paid in full before any junior class may share under the plan.

*Id.* at 413.

In summary of this point, it is clear that the "absolute priority rule" had a well and commonly understood meaning--a meaning which did not allow for participation in a reorganization plan by debtors in return for nothing more than a contribution of labor or expertise. Congress was urged to change that rule but declined to do so in favor of carrying forward the existing understanding into the new Bankruptcy Code. The Eighth Circuit's opinion flies in the face of this legislative history.

The legislative history applicable to this case does not stop with the enactment of the Bankruptcy Reform Act of 1978. To the contrary, it continues to and beyond the date the Eighth Circuit handed down its opinion in this case, July 2, 1986.[6]

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[6] Ordinarily, subsequent legislative history is of little value in determining the intent of the Congress which enacted the relevant statute. Here, however, Congress's later actions are far more substantive in nature than merely an expression of opinion about its predecessors' work. As we show below, when Congress enacted the Family Farmer Bankruptcy Act it acted with an explicit understanding of what the then current state of the law was--an understanding at odds with the Eighth Circuit's. When Congress acts, it is presumed to know the state of the law. *Lorillard v. Pons*, 434 U.S. 575, 580-81 (1978).



It is important to note at this point that it is merely coincidental that the *Ahlers* case happens to involve a farm bankruptcy. The Court's opinion, since it construes 11 U.S.C. Section 1129, is applicable to *all* business reorganizations. Four months after the Court's decision, the Family Farmer Bankruptcy Act (11 U.S.C. Chapter 12) became law. It was intended to, and did, modify the absolute priority rule so as to make it look very much like the Eighth Circuit said the absolute priority rule *already* looked under preexisting law. Because there are various qualifications and limitations set forth by Congress in new Chapter 12, which do not conform to the Eighth Circuit's understanding of Chapter 11, it is impossible to reconcile those two chapters of the Bankruptcy Code unless the Eighth Circuit's opinion is reversed. As this Court has held, "courts are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of coexistence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Morton v. Mancari*, 417 U.S. 535, 551 (1974).

The Eighth Circuit's decision, applying Section 1129 of the Bankruptcy Code, has the effect of allowing farmers to retain possession of and an interest in the property and to participate in the reorganization plan in return for their contributions of experience, knowledge and labor to the plan. The new Family Farmer Bankruptcy Act achieves the same result, but it was passed specifically because Congress understood that that result could *not* be achieved under preexisting law--including Section 1129.

Under the new Act, farmers filing under Chapter 12 may retain property even though unsecured creditors are not paid in full and even though they do not approve the plan. The Act eliminates the application of the absolute priority rule to Chapter 12 debtors. The legislation was in direct and specific response to complaints that farmers were unable to reorganize under Chapter 11 and instead were forced to liquidate, in large part because of the absolute priority rule that required that the debtor retain no property.

Senator Grassley, one of the principal Senate sponsors of the Family Farmer Bankruptcy Act told his colleagues that "the Bankruptcy Code doesn't work for farmers."[7] As an explanation of this conclusion, he incorporated into his remarks by reference a law review article which "contains a detailed analysis of existing bankruptcy laws and persuasively argues that these laws are inadequate for family farmers." *Id.* That article, in turn, attributes the family farmers' problems, in part, to the existing absolute priority rule:

> The new Bankruptcy Code precludes a debtor from obtaining a discharge of excessive liabilities without the creditors consent, because the "cram down" standards in Chapter 11 reorganizations incorporate the rule of absolute priority. Therefore, any dissenting impaired class of creditors is entitled to full compensation before any junior ownership interests may retain anything of value (e.g., continued ownership of stock or property of

[7] 132 Cong. Rec. S-15,076 (daily ed. Oct. 3, 1986).



> the debtor) unless the holders of the valueless ownership interests contribute new capital necessary for ongoing business operations or funding of the plan in which case the holders of ownership interests may be allowed to retain their financial stake in the reorganized business entity.
>
> This rule (of absolute priority) causes substantial difficulties for overleveraged farmers to gain rehabilitation under Chapter 11 of the Code, since it is very difficult to negotiate and confirm plans of reorganization requesting or requiring creditors to take less than full payment. Assuming the debtor can confirm a plan over the dissent of an impaired class of creditors in order to keep his farm, he must still, in cramming down on this class, pay it in full. This creates many situations where farmers come out of reorganization highly leveraged (after going into the reorganization case with too much debt) causing them to fail to consummate and fully complete their plans, because they cannot force a composition (and correspondingly discharge of excess debts) on creditors via a cram down under Chapter 11 of the Code. Therefore, the rule of absolute priority, applied in farmer reorganization cases under Chapter 11 often perpetuates the initial problem, that is, heavy indebtedness that cannot be repaid because of the diminished sales prices for crops created by over- production. Further, farmer plans which are required by the rule of absolute priority to repay substantial debts un-

der any fixed repayment schedule will always be subject to the issue of whether they are feasible, that is, whether the debtor will be able to meet these fixed repayment schedules in the future, especially in the face of the fluctuations in the farm economy and the possibility of crop loss due to natural forces beyond the debtor's control (e.g., inclement weather, insect infestation, etc.).

Therefore, the present provisions of Chapter 11 are inadequate for the rehabilitation of financially distressed farmers who have excessive liabilities, since it is virtually impossible to confirm a plan of discharging the excess debts (which is the primary relief needed by such farmers) unless all impaired classes of creditors consent to the composition offered (which is an improbable result in most cases).[8]

On this basis, the legislators remedied the problem by eliminating application of the absolute priority rule to family farmers. 11 U.S.C. § 1203. Under the new law, the debtor can be removed from possession only "for cause, including fraud, dishonesty, imcompetence or gross mismanagement of the affairs of the debtor" 11 U.S.C. § 1204. The law was designed to give farmers "a fighting chance to . . . keep their land." (Joint Explanatory Statement of the Committee of Conference, *reprinted in* 132 Cong. Rec. H-8,999 (daily ed. Oct. 2, 1986)).

The Family Farmer Bankruptcy Act makes sense *only* if the Eighth Circuit's decision in this case is

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[8] 132 Cong. Rec. S-15,082 (daily ed. Oct. 3, 1986).



wrong. If the Eighth Circuit is correct, then it is clear that preexisting bankruptcy law *does* work for family farmers like the Ahlers, and Congress's efforts in enacting the new law were wholly superfluous.

The new law's general thrust is to provide certain benefits to family farmers which, according to Congress's understanding, did not exist in then current law. But the benefits were not conferred without limitations. Congress specifically instructed that the new Chapter 12 was to be applied to cases filed after November 26, 1986 only. *In Re Waetjen*, No. BKY 4-86-3335, slip op. at 2 (Bankr. D. Minn. Nov. 26, 1986). Here, by virtue of the Eighth Circuit's decision, the Ahlers receive the substantive benefit of the new legislation, retroactively, under the guise of an interpretation of the preexisting law, even though their case was filed long before November, 1986. Congress specifically designed new Chapter 12 as an "experimental" and "temporary" provision in the law (132 Cong. Rec. S-15,076 (daily ed. Oct. 3, 1986) (statement of Sen. Grassley)) which will "sunset" in seven years (Joint Explanatory Statement of the Committee of Conference, *reprinted in* 132 Cong. Rec. H-8,999 (daily ed. Oct. 2, 1986)). Here, the Eighth Circuit's opinion disposes of the absolute priority rule as a matter of interpretation of the permanent provisions of the Bankruptcy Code. Abolition of the absolute priority rule under the new law is limited to family farmers (11 U.S.C. § 109(f) (as added by Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Section 252, *reprinted in* 132 Cong. Rec. H-8,991 (daily ed. Oct. 2, 1986)). The Eighth Circuit's decision, however, is not limited to family farmers. Self-evidently, it extends to any busi-

ness reorganization which could be filed under preexisting Chapter 11 of the Code. Finally, there are several procedural requirements with respect to a Chapter 12 filing which are somewhat stricter than those applicable to Chapter 11 proceedings. For example, a family farmer, seeking to take advantage of Chapter 12, must file a plan not later than 90 days after the order for relief. 11 U.S.C. 1221. The same debtor, filing under Chapter 11, has 180 days to do so. 11 U.S.C. § 1121. (Compare also Section 1208 pertaining to conversion or dismissal of a Chapter 12 plan with Section 1112 covering the same subject matter with respect to Chapter 11 plans.) To the extent that Chapter 11 procedures are more favorable to the debtor, there is no particular reason for the debtor, even if eligible, to take advantage of Chapter 12, if the same substantive benefits are available to the debtor under Chapter 11. The Eighth Circuit, for all intents and purposes, held that they are, and thus rendered meaningless the Congressional efforts.

## CONCLUSION

The absolute priority rule has a long history. It permits participation in a reorganization plan to equity owners of the bankruptcy estate, in those cases where unsecured creditors cannot be fully provided for, only in return for the infusion by the owners of money or money's worth. Money or money's worth has been commonly understood to exclude promises of intangible future contributions--understood especially by Congress when it enacted the Bankruptcy Reform Act of 1978, and again when it enacted the Family Farmer Bankruptcy Act in 1986. The Eighth Circuit panel decision exhibits a considerably different



understanding of the absolute priority rule, which is at variance with the plain meaning of the relevant statutes and their legislative history. If allowed to stand, the dichotomy between the two understandings will inevitably result in irreconcilable conflicts between Chapter 11 and Chapter 12 of the Bankruptcy Code, a legally intolerable result. The Eighth Circuit decision should be reversed.

Respectfully submitted,

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August 6, 1987

# AMICUS CURIAE

# BRIEF

Supreme Court, U.S.
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No. 86-958

In The
# Supreme Court of the United States
October Term, 1986

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondents.*

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT**

## BRIEF OF THE NEBRASKA BANKERS ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE PETITIONERS

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## BRIEF AMICUS CURIAE OF THE NEBRASKA BANKERS ASSOCIATION, INC.

### NATURE OF INTEREST OF AMICUS CURIAE

The Nebraska Bankers Association, Inc., (the "NBA") is a trade association having as its members 430 of the 435 commercial banks in Nebraska. Member banks of the NBA serve as the principal providers of credit to individuals, businesses, and agricultural entities in the State of Nebraska. Lending decisions by member banks have historically been made with consideration given to the application of the bankruptcy code and its effect on the bank's legal rights should a borrower elect to file a Chapter 11 Bankruptcy. Heretofore, lending practices of Nebraska banks have been predicated upon the refusal of bankruptcy courts under well established legal principles, to permit a debtor to retain an equitable ownership interest in the debtor's property and participate in the reorganization plan ahead of unsecured creditors who have a senior interest in the estate, in the absence of full payment to unsecured creditors.

The decision of United States Court of Appeals for the Eighth Circuit is of major importance to the NBA, not only due to its impact in this particular case, but also because of the uncertainty that it will cause its member banks to face in extending credit in the future. The overthrow of the well-established rule of priority set forth in 11 U.S.C. Section 1129(b)(2)(B) will most certainly inject further caution into the decision to extend credit to business and agricultural customers. The resulting restrictions on the availability of credit come at a time when the business and agricultural communities can least afford it.

The NBA feels an obligation as the industry most directly affected by the Court of Appeals decision to express its support for the petitioners and files this brief, *Amicus Curiae,* with the consent of the parties pursuant to Rule 36.1 of this Court.

## ARGUMENT

### I. THE COURT BELOW VIOLATED ESTABLISHED LEGAL PRINCIPLES OF ABSOLUTE PRIORITY UNDER 11 U.S.C. SECTION 1129(b)(2)(B) BY HOLDING THAT A BANKRUPTCY DEBTOR, BY A MERE PROMISE OF FUTURE LABOR, EXPERIENCE AND EXPERTISE, MAY RETAIN OWNERSHIP OF THE REORGANIZED ENTERPRISE WITHOUT PAYING DISSENTING CREDITORS IN FULL.

Sound public policy and strong consideration of the currently depressed farm economy dictate that an equitable balance between the rights of creditors and debtors be reached so that the free-flow of credit in commercial business and agricultural transactions may be maintained. However, the decision of the Court of Appeals in the above proceedings has thrown the rights of creditors and debtors completely out of balance.

While couched in terms of compassion and sympathy, the Court's ruling has served to destroy the reasonable commercial expectations of lenders in entering into financial transactions and has transferred a majority of the risk of loss from farm debtors to their creditors. In establishing new public policy by judicial mandate in the



area of Chapter 11 reorganization bankruptcies, the Court has effected an unwarranted intrusion into an area traditionally and more appropriately left to our legislative bodies. In the process, the plain meaning of established statutory provisions have been ignored and well-established precedents have fallen by the wayside. The feared result of this judicial policy-making is the further restriction of farm credit and increases in the cost of obtaining agricultural loans at a time when it can least be afforded.

#### A. THE PROVISIONS OF 11 U.S.C. SECTION 1129(b)(2)(B)(ii) AND THE LEGISLATIVE HISTORY BEHIND THAT SECTION PRECLUDE ANY JUDICIAL EXPANSION OF THE ABSOLUTE PRIORITY RULE TO INCLUDE EXPERIENCE, KNOWLEDGE AND LABOR AS CAPITAL CONTRIBUTIONS.

The provisions of 11 U.S.C. Section 1129(b) set forth that a plan of reorganization *cannot* be confirmed over the dissent of a class of unsecured claims unless those claims are paid in full, or in the alternative, that no junior interest holder, whether stockholder, partner or sole proprietor, may receive or retain any property under the plan on account of such interest. This section, which establishes the so-called "absolute priority rule" requires that a plan of reorganization be fair and equitable before being considered for confirmation.

The court below established a "modified version" of the traditional absolute priority rule by holding that there may be circumstances under which the absolute priority rule can be modified to allow participation by a junior class, even though senior creditors are paid less than their full claims. This act of judicial juggling has resulted in

the use of a farmer's experience, knowledge and labor as capital equivalents for purposes of allowing the confirmation of a plan for reorganization, notwithstanding the dissent of unsecured creditors.

In essence, the Court has performed a bit of judicial magic by creating an exception to 11 U.S.C. Section 1129(b) where none exists. However, the plain meaning of 11 U.S.C. Section 1129(b) provides no basis for such an exception.

The basic rules of statutory construction do not permit the creation of a "judicial exception" to Section 1129(b). The primary rule of statutory construction requires the court to initially consider the plain language of the statute. In the absence of any ambiguity, the Court is to construe the statute as drafted without reference to legislative history. (*See in re Ray*, 26 B.R. 534, 541-42 (D. Kansas 1983). This rule prevails in the Eighth Circuit. In *U.S. vs. Archambault*, 767 F.2d 402 (8th Cir. 1985) the Court held "[i]f the plain language of the statute is clear in its context, it is controlling." *Id.* at 404. *See also Bailey v. FLCB*, 788 F.2d 498, 500 (8th Cir. 1986). In the case of *Highland Supply Corp. v. Reynolds Metal Co.*, 327 F.2d 725 (8th Cir. 1964) the Court concluded:

> In the light of the controlling authority, we can find no ambiguity in the terms "civil or criminal proceedings" as used in that section of the Clayton Act, as these parties apparently do. *Hence, "we do not inquire what the legislature meant (by use of such terms); we ask only what the statute means."* [citations omitted]. . . . "Resort to legislative history is only justified where the face of the Act is inescapably ambiguous."

*Id.* at 730 (emphasis added).



This analysis of the fundamental rules of statutory construction clearly indicates that the lower court's reasoning was seriously flawed. Section 1129(b) simply does not provide for any exception. Furthermore, Section 1129(b) is clearly not ambiguous in providing that "fair and equitable" includes the requirement of nonparticipation by junior classes in the absence of full payment to unsecured claims and requires no judicial interpretation to derive its true meaning.

Even assuming *arguendo* that it is necessary to resort to the legislative history surrounding the adoption of 11 U.S.C. Section 1129(b), the legislative history does not lend support to the lower court's ruling. The most telling legislative history is included in the floor statements which are entitled to great weight. In the case of *In re Spong*, 661 F.2d 6 (2d Cir. 1981) the Court, with respect to the floor statements of Congressman Edwards and Senator Deconcini concerning Section 523 of the Bankruptcy Code stated:

> These remarks, offered in lieu of a conference report by the principal sponsors of the act, are entitled to great weight.

*Id.* at 10.

In discussing the application to be accorded 11 U.S.C. Section 1129(b)(2)(B)(ii), Congressman Don Edwards, in his floor statements, stated as follows:

> Alternatively, under Clause (ii) the Court must confirm the plan, *if the plan provides that holders of any claims or interests junior to the interests of the dissenting class of impaired unsecured claims will not receive any property under the plan on account of such junior claims or interests. As long as senior*

> *creditors have not been paid more than in full, if classes of equal claims are being treated so that the dissenting class of impaired, unsecured claims is not being discriminated against unfairly, the plan may be confirmed if the impaired class of unsecured claims receives less than 100 cents on the dollar (or nothing at all) as long as no class junior to the dissenting class receives anything at all.* Such an impaired, dissenting class may not prevent confirmation of a plan by objection merely because a senior class has elected to give up value to a junior class that is higher in priority than the impaired dissenting class of unsecured claims, as long as the above safeguards are met.

124 Cong. Rec. H 11089 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards) (emphasis added).

The foregoing floor statement makes it clear that no junior class may retain or receive anything unless the senior class is paid in full. Courts generally assume that Congress knew or understood the judicial gloss which may have been given to statutory language, and courts presume that Congress adopted such gloss or interpretation when those terms are used in a statute, unless Congress affirmatively acts to change the meaning. *See Blitz v. Donovan*, 740 F.2d 1241 (D. Col. 1984). In the case of *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 106 S.Ct. 755 (1986), the Supreme Court held:

> Thus, when Congress enacted Section 554, there were well recognized restrictions on a trustee's abandonment power. In codifying the judicially developed rule of abandonment, Congress also presumably included the established corollary that a trustee could not exercise his abandonment power in violation of certain state and federal laws. *The normal rule of statutory construction is that if Congress intends for legislation*



> *to change the interpretation of a judicially created concept, it makes that intent specific.* [citations omitted.] The Court has followed this rule with particular care in construing the scope of Bankruptcy codifications.

*Id.* at 759-60 (emphasis added).

Prior to the adoption of the present Bankruptcy Code, Chapter X had, as a standard of confirmation, a requirement that the bankruptcy plan be "fair and equitable". The term "fair and equitable" was undefined under the old Bankruptcy Code and received its meaning by way of judicial interpretation pursuant to a series of early Supreme Court cases. *See Louisville Trust Company v. Louisville, New Albany and Chicago Railway Company*, 174 U.S. 674, 1898; *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1912); *Kansas City Terminal Railway Co. v. Central Union Trust Co.*, 271 U.S. 445 (1925); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

Through the legislative process of enacting the Bankruptcy Code, it is apparent that Congress intended to change the meaning and intent of "fair and equitable" and thereby remove the judicial gloss previously accorded to this term. In the present Code, Congress defined "fair and equitable" as opposed to simply using that term which under rules of statutory construction, would incorporate the judicial gloss. Moreover, Congress did not provide for any exception. As concluded by the court in *Klein v. Republic Steel Corporation*, 435 F.2d 762 (3rd Cir. 1970):

> It is a canon of statutory construction that whereas *here the words of a later statute differ from those of a previous one on the same or a related subject, the*

> *legislature must have intended them to have a different meaning.*

*Id.* at 765-66 (emphasis added).

Since the term fair and equitable is used in Section 1129(b), the specific definition would control over any judicial gloss which may have previously helped to define fair and equitable. Specific terms in a statute control over general terms. *See Fourco Glass Company v. Trans Mirra Products Corporation*, 77 S.Ct. 787, 790 (1957). Section 1129 expressly defines fair and equitable, and a "statutory determination declaring what a term means excludes any other meaning." *In re Bartley*, 33 B.R. 768, 771 (E.D. N.Y. 1983); *Colautti v. Franklin*, 99 S.Ct. 675, 684 (1979). In the case of *In re Lewis*, 5 B.R. 575 (N.D. Ga. 1980), the Court held:

> It is a general rule of statutory construction that when certain matters are *expressly* provided for in a statutory provision, other matters which were not included in the express provision are excluded by implication.

*Id.* at 576 (emphasis added).

The lower Court in this proceeding held that notwithstanding the plain language of Section 1129(b), there is an "exception" which permits debtor participation in the plan, retention of title, and possession and use of assets. This exception, based upon the Supreme Court decision in *Case v. Los Angeles Lumber Products Company*, supra, [a case decided nearly 40 years prior to the enactment of the Bankruptcy Code], was based upon *judicially* developed doctrines, and statutes which incorporated these doctrines. However, a review of the legislative history of 11 U.S.C. Section 1129(b) clearly reveals that although such an exception was considered by Congress, it was ultimately rejected by the adoption of 11 U.S.C. Section 1129(b) in its present form.



In tracing the legislative history underlying the enactment of 11 U.S.C. Section 1129(b), it is important to note that in 1970, Congress established the Commission on Bankruptcy Laws. In July of 1973, the Commission submitted its report and findings to Congress, and in addition, submitted proposed legislation. After tracing the history of the absolute priority rule, the Commission determined that the rule was deficient. The Commission recommended that the rule be relaxed and modified "by allowing stockholders to participate if their future contribution, i.e., continued management, is essential to the business." *Report of Commission on Bankruptcy Laws of the United States*, H.R. Doc. 137, 93d Cong. First Session 254 (1973). Such provisions, intended to relax the absolute priority rule, particularly in terms of delayed participation, and participation based upon future management, were severely criticized at public hearings conducted by the Commission, and were deleted from the legislation which was ultimately adopted.

The fact that Congress rejected the concept of a modified absolute priority rule which would have permitted participation by owners or stockholders based on management, or would have provided for delayed participation rights is significant in determining legislative intent. *See Russello v. U.S.*, 464 U.S. 16, 23 (1983). This is particularly true when the statute enacted is significantly contrary to and different from the original proposed statute. *See Tahoe Regional Planning Agency v. McKay*, 769 F.2d 534, 538 (9th Cir. 1985).

Further resort to rules of statutory construction with regard to legislature history shows that the language of Section 1129(b) must be taken at face value, without infusion of any judicial gloss. In the case of *Israel-British Bank, Ltd. v. The Federal Deposit Insurance Corporation*, 536 F.2d 509 (2d Cir. 1976) the Court stated with respect to statutory interpretation:

> Since we cannot find a final answer in the words themselves, we must employ other methods. *We may consider the history of the phrase as it finally evolved*, with particular reference to the language used in earlier statutes. . . . When the words create a *general inclusionary category there is greater reason, perhaps, to accept a literal meaning in the absence of any particular purpose which contradicts it.*

*Id.* at 512 (emphasis added).

In *Turpin v. Mailet*, 579 F.2d 152 (2d Cir. 1978) the Court concluded:

> In sum, we take issue with those who find guidance in congressional inaction. Congress acts only by affirmatively passing laws, a process which requires the concurrence of both Houses, and, in most instances, the approval of the President. Admittedly, in interpreting an enacted provision, *it may be appropriate to review the legislative history of the measure, including provisions that were earlier rejected.* There, of course, one is merely determining congressional intent as embodied in positive law.

*Id.* at 163 (emphasis added).

In *Zeller v. U.S.*, 467 F.Supp. 487, 498 (E.D. N.Y. 1979) the Court held that "One factor to be considered in the 'search for legislative purpose' is the history of the statutory language as it finally evolved." *See also In re Blanton Smith Corp.*, 7 B.R. 410, 414 (M.D. Tenn. 1980).



In *Russello vs. U.S.*, supra (1983), the Supreme Court held, with respect to rules of statutory construction:

> The evolution of these statutory provisions supplies further evidence that Congress intended Section 1963 (a)(1) to extend beyond an interest in an enterprise. An earlier proposed version of RICO, S 1861, 91st Cong., 1st Sess. (1969), had a single forfeiture provision for Section 1963(a) that was limited to "all interest in the enterprise." This provision, however, later was divided into the present two subsections and the phrase "in the enterprise" was excluded from the first. *Where Congress includes limiting language in an earlier version of the bill but deletes it prior to an enactment, it may be presumed that the limitation was not intended.*

*Id.* at 23-24 (emphasis added).

In *Gulf Oil Corporation v. Copps Paving Company*, 419 U.S. 186 (1974), the Court concluded:

> The conference Committee, however, deleted this "effects on commerce" provision, leaving only the "in commerce" language of Section 2(a). Whether *Congress took this action because it wanted to reach only price discrimination in interstate markets or because of its then understanding of the reach of the commerce power, its action strongly militates against a judgment that Congress intended a result that it expressly declined to enact.*

*Id.* at 200 (emphasis added).

In *Muniz v. Hoffman*, 422 U.S. 454 (1975), the Court with respect to rules of statutory construction and the prior legislative process held:

> Just as Section 3692 may not be read apart from other relevant provisions of the labor law, that section likewise may not be read isolated from its legislative history and the revision process from which

> it emerged, all of which place definite limitations on the latitude we have in construing it.

*Id.* at 468.

In enacting Section 1129(b) Congress considered specific legislation that would have permitted participation based on management or labor and provisions for delayed participation rights. Those provisions were criticized and never adopted. Instead, a statute was adopted with specific guidelines and minimum requirements for the court to use in determining whether a plan may be confirmed over the objection of a dissenting class of unsecured claims. Section 1129(b) states affirmatively that "fair and equitable" under 1129(b) *includes* the requirement that no junior class may receive or retain any property in the absence of full payment and makes no provision for any exception. Further, the direct legislative history does not provide any basis for the exception carved out by the lower Court. Rather, it specifically and categorically states that no junior interest may receive or retain *any* property in the absence of full payment to unsecured creditors.

Chapter 11 permits a "cramdown", but the owner or junior interest holder cannot force the dissenting class of unsecured claims to accept less than full payment and at the same time retain his property in *any* future going concern value. The trade-off for the ability of a debtor to use cramdown is a rule that the owners or stockholders cannot particiapte if the cramdown is for less than full payment. This is the balancing of interests as reflected by Congress, which recognizes the basic priority of creditors to the assets of the business over the interest of the owner or stockholders. That balance permits the owner or stockholder to participate if they can get a majority of creditors



to accept the proposed plan, and precludes participation if unsecured creditors are not faid in full. A relatively simple and fair balancing of interests until disturbed by the decision of the lower court. If the majority of creditors do not accept the plan, then "fairness" is violated if the owner/stockholders, the same owner/stockholders who managed the business into bankruptcy to start with, participate in the absence of full payment to creditors.

The lower court's decision has cast uncertainty into this vital issue of federal bankruptcy law. The decision below runs counter to the express language and legislative history underlying 11 U.S.C. Section 1129 (b)(2)(B)(ii), and contradicts a long line of case law in other Circuits which have addressed this issue. This court should therefore overturn the lower court's decision which allows a debtor, whose management skills contributed to a bankruptcy proceeding, to retain his property and benefit at the expense of his creditors by promising future labor, service and management.

## CONCLUSION

If the lower court's decision is allowed to stand, it will have a significant adverse impact on the cost and availability of agricultural and commercial credit in Nebraska and other states in the Eighth Circuit. The court below has ignored the proper roles to be played by the legislative and judicial branches of government at a time when careful consideration of, and meaningful solutions to the agricultural crisis are most needed.

The issues presented are serious and of grave concern for all creditors in Chapter 11 Bankruptcy Proceedings, and the amicus curiae respectfully requests that this court reverse the decision of the United States Court of Appeals for the Eighth Circuit.

Dated August 4, 1987.

Respectfully submitted,

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# AMICUS CURIAE

# BRIEF

Supreme Court, U.S.
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No. 86-958

In The
# Supreme Court of the United States
October Term, 1987

NORWEST BANK WORTHINGTON, and
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

vs.

JAMES R. AHLERS and MARY M. AHLERS,
*Respondent.*

## ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

## BRIEF AMICUS CURIAE OF THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS IN SUPPORT OF THE PETITIONERS

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## QUESTION ADDRESSED

The question addressed by the *Amicus Curiae* is as follows: is a promise of future labor a present contribution of capital that would enable a debtor to retain an interest in property without compensating unsecured creditors as required by 11 U.S.C. section 1129(b)(2)(B)?

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## INTEREST OF THE AMICUS CURIAE

The American College of Real Estate Lawyers was organized on April 28, 1980, as a nonprofit corporation for the purpose of gathering together lawyers distinguished for their skill, expertise and high standards of professional and ethical conduct in the practice of real estate law, in order, *inter alia*, "to improve and reform real estate law and practice" (Articles of Incorporation at 2). Those elected to the College (which has a membership that includes attorneys from every state and the District of Columbia who represent borrowers, lenders, purchasers, sellers, developers and institutional investors) are required to have concentrated their practice in real estate law for a period of not less than ten years. Additional requirements established by the Board of Governors include a demonstrated willingness to devote time to improving real property law, including writing, teaching or participating in organized bar projects.

This brief supports the position of the Petitioners in this case. Due to the background of its members, the *amicus* is particularly qualified to offer to this Court its expertise in the significant real property issues involved in this case and to advise of the serious impact that the holding below, if not reversed, could have on real estate bankruptcies, real estate mortgagees, and the real estate industry.

—o—

## SUMMARY OF ARGUMENT

The decision below that a promise of future work entitles the debtor to retain collateral under a plan of reorganization, while unsecured creditors remain unpaid, has

no basis in the language of Section 1129(b)(2)(B) of the Bankruptcy Code, or applicable decisional law. It violates Congress' clear intention to overcome the *Pine Gate* line of cases under Chapter XII of the former Bankruptcy Act, which had produced a result similar to *Ahlers,* and if not reversed, would have a severe adverse impact on mortgage lending and the real estate industry.

—o—

## ARGUMENT

### I. THE COURT BELOW ERRED IN HOLDING THAT A DEBTOR'S PROMISE OF FUTURE WORK WAS SUFFICIENT TO MODIFY THE ABSOLUTE PRIORITY REQUIREMENTS OF SECTION 1129(b)(2)(B) OF THE BANKRUPTCY CODE (11 U.S.C. SECTION 1129(b)(2)(B)).

#### A. The Eighth Circuit's decision in Ahlers has no basis in the language of 11 U.S.C. section 1129(b)(2)(B) or in the legislative purpose for which it was adopted, and is contrary to the decision of this Court in Case v. Los Angeles Lumber Products Co., 308 U.S. 96 (1939).

Section 1129(b)(2)(B) of the Bankruptcy Code clearly requires that, with respect to the dissenting impaired class of unsecured claims, the plan must provide "that each holder of a claim . . . receive . . . property of a value . . . equal to the allowed amount of such claim" before the holder of a junior claim or interest may "receive or retain . . . any property." By permitting the debtor in the plan of reorganization to retain an interest in the property without fully compensating the dissenting, impaired unsecured creditor class, the decision below clearly violates the unambiguous absolute priority requirements of section 1129



(b)(2)(B) of the Bankruptcy Code. It represents an inappropriate application and distortion of the decision of this Court in the *Los Angeles Lumber* and similar cases.

The Congressional intent is clear:

> [U]nder clause (ii) [of 11 U.S.C. section 1129(b)(2)(B)], the court must confirm the plan if the plan provides that holders of any claims or interests junior to the interests of the dissenting class of impaired unsecured claims will not receive any property under the plan on account of such junior claims or interests. . . . [T]he plan may be confirmed if the impaired class of unsecured claims receives less than 100 cents on the dollar (or nothing at all) *as long as no class junior to the dissenting class receives anything at all.*

124 Cong. Rec. 17421 (daily ed. October 6, 1978) (statement of Senator DeConcini) (emphasis added).

The quoted commentary clearly indicates that Congress intended to prohibit debtors from retaining property under the plan of reorganization at the expense of the dissenting, impaired unsecured creditor class, an intent obviously ignored by the holding of the court below. The Eighth Circuit, in overriding both the language of the Bankruptcy Code and the intention of Congress, argued that it was applying the corollary to the absolute priority rule of *Los Angeles Lumber,* under which a party contributing new capital could, in effect, buy an interest equal to such contribution, even though senior creditors were not paid in full. In *Los Angeles Lumber,* however, this Court held that, the "participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to [such] participation," (*Los Angeles Lumber,* 308 U.S. at 122), and rejected participation based on a contribution of intangible hopes and unenforceable promises having no place on a balance sheet. *Id.* at 122-

123. Thus, the holding below that a promise to work in the future constitutes such present capital is not only inconsistent with the language and purposes of the Bankruptcy Code but also with the very decision of this Court it cites. It has already been rejected by several bankruptcy courts. *See, In Re Stegall,* 64 B. R. 296 (Bankr. C.D. Ill. 1986), and *In re Sawmill Hydraulics,* 72 B. R. 454 (Bankr. C. D. Ill. 1987). And even bankruptcy courts in the Eighth Circuit, bound by *Ahlers,* have noted that it represents a marked departure from traditional bankruptcy law. *See, In re Baugh,* 73 B. R. 414 (Bankr. E.D. Ark. 1987), and *In re C&P Gray Farms, Inc.,* 70 B. R. 704 (Bankr. W.D. Mo. 1987).

Often the cause of the failure of a real estate project is poor management. *See e.g.,* Blumenfeld, *Saving Problem Loan and Residential Income Properties,* 5 Real Estate Rev. No. 2, 58 (Summer 1975). However, even in the worst of times, while the number of failures increase, many projects continue to be successful. Sometimes this is due to location. More and more often today it is due to management. Deferred maintenance, poor tenant relations and failure to give tenants proper attention frequently cause the down-hill slide. An undertaking to work in the future, by a debtor whose work in the past may have caused the problem, should not be allowed to deprive a mortgagee of its bargained-for rights, contrary to Congressional intent.



**B. The decision below deprives the mortgagee of absolute priority for its unsecured claim and thereby undermines the protection for the mortgagee built into the Bankruptcy Code by Congress.**

**1. Absolute Priority**

The decision below ignores the intent of Congress that reorganization plans be confirmed only if they are "fair and equitable" as to dissenting impaired classes; that is, unless the principle of absolute priority is observed. This is of critical importance to the real estate industry. Absolute priority for the mortgagee's unsecured claim (the claim of the mortgagee in excess of the value of the collateral as determined under Section 506(a)) of the Bankruptcy Code, 11 U.S.C. Section 506(a) is the linchpin in the package of protection built into the Bankruptcy Code by Congress to protect mortgagees in this very type of situation.

Absolute priority for the mortgagee's unsecured claim prevents the debtor in a plan of reorganization from keeping the property without satisfying the claims of creditors. The decision below would destroy absolute priority for the unsecured claim based on a debtor's mere promise to work in the future. This would permit the court to confirm a chapter 11 plan under which the debtor gets the property while debts to unsecured creditors (including the unsecured portion of a mortgagee's claim) remain unpaid. The mortgagee would be left with a mortgage reduced to the depressed value of the property, without compensation for the amount of the debt exceeding the value of the property. Congress intended to avoid such a result when it required absolute priority in section 1129(b)(2)(B).

## 2. Pine Gate Line of Cases

A major purpose of Section 1129(b)(2)(B) was to overcome the so-called "*Pine Gate*" line of cases that would have done to non-recourse mortgagees what *Ahlers* below would do to all mortgagees. *See In re Pine Gate Assoc., Ltd.*, 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976). Those cases under Chapter XII of the former Bankruptcy Act would have given the mortgaged property to the borrower, while paying the non-recourse mortgagee the depressed value of the collateral, leaving such mortgagee with no compensation for the amount of the debt exceeding the property value.

To overcome this, Congress specifically provided in the Bankruptcy Code that every undersecured mortgagee would be able to have an unsecured claim for the debt in excess of the property value, and that the dissenting, impaired unsecured class would be afforded absolute priority. Thus, the debtor would not be able to keep the property while unsecured debts remain unpaid.[1]

The legislative history surrounding the *Pine Gate* controversy is instructive. Prior to the adoption of the Bankruptcy Code, *Pine Gate* and similar cases under Chapter XII of the former Bankruptcy Act (then 11 U.S.C. Sections 801-926) had given rise to very grave concern on the part of the real estate industry. Chapter XII dealt with

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1. *See* 5 *Collier, Bankruptcy,* para. 1111.02[2] (15th (L. King) ed. 1986); L. Cherkis, *Collier Real Estate Transactions and the Bankruptcy Code,* section 1.11 (King ed. 1985); Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative,* 39 Bus. Law. 441 (1984); and S. Rep. No. 989, 95th Cong. 2d Sess. 65 *reprinted in* 1978 U.S. Code Cong. & Admin. News 5851 (1978), (commenting on section 502(i) an earlier version of section 1111(b)).



"Real Property Arrangements for Persons other than Corporations." The requirement that a reorganization plan had to be "fair and equitable" that is, that absolute priority was required for confirmation of a plan, had been removed from Chapter XII in 1952 (66 Stat. 435 (1952)) in order to permit debtors to effectuate a plan by "scaling of debts". *See* S. Rep. No. 1395, 82nd Cong., 2d Sess. 11 (1952); *See also,* to the same effect, H.R. Rep. No. 2320, 82nd Cong., 2d Sess. 21, *reprinted in* 1952 U.S. Code Cong. & Admin. News, 1960, 1982. However, under section 461 (11) (then 11 U.S.C. section 861) of Chapter XII, a plan might be confirmed over the objection of particular classes of creditors, only if those classes were given "adequate protection."

Subsection (c) of section 461(11) provided that the adequate protection requirement would be met if the dissenting classes were paid the *value of their debts in cash.* The *Pine Gate* line of cases, interpreting this subsection, held that the value of the mortgage indebtedness where the debt is non-recourse (as has been normal in many commercial real estate mortgage transactions) is equal to the value of the collateral. Since reorganization often occurs under depressed market conditions, the value of the collateral would often be less than the amount of the debt. For example, in *In re KRO Assoc.,* 4 Bankr. Ct. Dec. (CRR) 462 (Bankr. S.D.N.Y. 1978), where there were some $14 million in mortgages on the property, the court found the value of the property to be $895,000.

Under the *Pine Gate* line of cases, secured creditors willing to take the collateral in satisfaction of the debt were not permitted to do so. The plan would be confirmed, the debtor would keep the collateral free of the mortgages, and the secured creditors would be paid the then depressed

value of the collateral, which might be significantly less than the debt. Due to the non-recourse nature of the debt, the secured creditors would not have an unsecured claim for their loss.[2]

### 3. Absolute Priority in the Bankruptcy Code

As a direct response to the inequity of the *Pine Gate* line of cases, when the Bankruptcy Code was being drafted Congress was specifically asked to restore absolute priority to real estate arrangements and override *Pine Gate*.[3] Congress responded. It enacted a series of complex provisions as part of the Bankruptcy Code designed to protect the undersecured creditor by overcoming the *Pine Gate* rule. These provisions included sections 506(a), 1111(b) and 1129(b)(2). Together they (i) insure that the mortgagee may have both a secured claim for the value of the collateral and an unsecured claim for the difference between that value and the amount of the indebtedness, and (ii) provide absolute priority for each of these claims.

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2. While in *Ahlers* below, the mortgagee *has* an unsecured claim, the decision renders that claim of little value. Thus the result under *Pine Gate* is similar to *Ahlers*. However, the mortgagee is hurt more under *Ahlers* than under *Pine Gate* because (i) rather than receiving cash equal to the value of the collateral as was required in *Pine Gate*, under *Ahlers* below the mortgagee will receive only a lien, the payments under which the court has determined have a present value equal to the value of the collateral, and (ii) *Ahlers* applies to both recourse and non-recourse debt, while the *Pine Gate* rule dealt only with non-recourse debt.

3. *See, e.g.* Testimony of John J. Creedon on behalf of the American Council of Life Insurance, Hearings on S.2266 and H.R. 8200 before the Subcommittee on Improvements in the Judicial Machinery of the Senate Committee on the Judiciary, 95th Cong., 1st Sess. 853, 855-56 and 864-67 (1977) and materials cited *supra*, note 1.



By effectively reading absolute priority for the unsecured claim out of section 1129, the opinion below undermines this Congressional package of mortgagee protection. Specifically, this package was designed to protect the mortgagee in the following manner:

(a) *11 U.S.C. Section 506(a).* Under section 506(a), an allowed claim is a secured claim to the extent of the value of the collateral. The allowed claim of a secured creditor in excess of the value of the collateral is an allowed unsecured claim. Without more, this provision would not have provided the non-recourse mortgagee with an unsecured claim since the mortgagor is not personally obligated to pay the debt. Thus, even if absolute priority were accorded the secured claim, the *non-recourse* mortgagee would, by virtue of section 506(a) alone, be left, as in *Ahlers* below, with a lien equal to the value of the collateral and no protection for the difference between that value and the amount of the debt.

(b) *11 U.S.C. Section 1111(b).* To prevent such a result, Congress added section 1111(b). It provides that a non-recourse claim will be allowed or disallowed as if it were a recourse claim,[4] thereby insuring that every mortgagee would be entitled, on plan confirmation, to an unsecured claim for its unsatisfied balances.

(c) *11 U.S.C. Section 1129(b).* Next, section 1129 (b)(1) requires that the plan be "fair and equitable, with

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4. Alternatively, secured creditors may elect under section 1111(b)(2) to have a secured claim for the full amount of the indebtedness without an unsecured claim. However, since deferred cash payments under the lien for the full secured claim may have a present value on a court imposed confirmation plan cram-down as low as the value of the collateral (section 1129 (b)(2)(A)), it is the recourse claim that protects the secured creditor against the *Pine Gate* rule.

respect to each class of claims or interests that is impaired under, and has not accepted, the plan". Thus, whether a mortgage is recourse, or has been converted to a recourse claim under section 1111(b), the mortgagee may have absolute priority for both its secured and unsecured claims.

Under section 1129(b)(2)(A), absolute priority with respect to a class of secured claims will require that if the lien is retained on the property,[5] it will have a face amount equal to the allowed amount of the secured claim with a present value at least equal to the value of the collateral. As an example of the foregoing, a secured creditor with a mortgage of $15 million on property having a value at the time of bankruptcy of $10 million, would, on account of its secured claim, have a lien of $10 million, the payments under which would have a present value of $10 million.

The knot of protection for the mortgagee is tied with the absolute priority requirement with respect to the unsecured claim. Under section 1129(b)(2)(B) (the provision involved in this case) the dissenting impaired unsecured class must receive property of a value equal to the allowed amount of its claims before any one junior receives any property. In the example, a recourse mortgagee, or a nonrecourse mortgagee whose claim has been converted under section 1111(b), would have to receive on its $15 million dollar debt, before the debtor would be allowed to keep any property, a lien worth $10 million dollars on its secured claim plus property worth $5 million dollars on the unsecured claim. This is based on the principle that in bankruptcy the debtor's non-exempt property should be used to satisfy the debtor's debts.

5. Alternatives to retaining the lien include sale of the property in a manner protective of the secured claim or other methods that would provide for the realization by the mortgagee of the "indubitable equivalent" of its interest (*See* section 1129(b)(2)(A)(ii) and *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935)).



Of course, there may not be property available to pay the unsecured claim in full. However, the debtor will not be able to keep the property unless such debts are paid. This is the provision that was designed to overcome *Pine Gate* and would be countermanded by the decision below. If the debtor is permitted to keep the property without paying unsecured claims, simply by promising to work in the future, the foundation stone of mortgagee protection will have been removed from the Bankruptcy Code, and the mortgagee will have been relegated to a situation even more harmful than the *Pine Gate* rule[6], clearly in contravention of the intention of Congress and the language of the Bankruptcy Code.

———o———

## CONCLUSION

The misinterpretation of the plan confirmation provisions of the Bankruptcy Code by the Eighth Circuit below in *Ahlers* distorts the language of the Bankruptcy

6. *See* note 2, *supra*.

Code and the intention of Congress. While this case involves a farming operation, the legal conclusions are applicable to all Chapter 11 cases. Unreversed, the decision below will have a severe adverse impact on the real estate industry, tighten credit, increase litigation, further clog bankruptcy courts and leave uncertain the prospect of successful reorganizations under Chapter 11.

Literally billions of insurance policyholder, bank depositor, pensioner, trust and mortgagee dollars have been loaned to borrowers on the strength of real property collateral and the protection built into the Bankruptcy Code. These Bankruptcy Code provisions were written to protect lenders whose rights were seriously jeopardized by the *Pine Gate* rule and to mandate priorities not clearly available in the predecessor Bankruptcy Act. The decision below not only threatens the existing mortgage debt that these lenders hold, but also threatens the future of mortgage lending so important to the health of the national economy.

The American College of Real Estate Lawyers agrees with the Solicitor General in his May 1987 brief, *amicus curiae,* in this case, where he stated that the holding of the Eighth Circuit "and this Court's previous decisions are in irreconciliable conflict" (at p. 18), and that "[i]f the approach to absolute priority taken by the court of appeals were to proliferate, the debtor-creditor relationship would



be fundamentally and unjustifiably altered." (at p. 10). We urge reversal.

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# AMICUS CURIAE

# BRIEF

Supreme Court, U.S.
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No. 86-958

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1987

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NORWEST BANK WORTHINGTON, AND
FEDERAL LAND BANK OF ST. PAUL,
*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,
*Respondents.*

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**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

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## BRIEF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

---

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## QUESTION PRESENTED

Does the promise by a debtor to contribute labor and expertise in the future constitute a present contribution of capital enabling the confirmation of a plan of reorganization that does not meet the requirements of 11 U.S.C. § 1129(b)(2)(B)?

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*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## BRIEF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

This brief is filed on behalf of the American Council of Life Insurance as *amicus curiae*, in support of Petitioners.[1]

### INTEREST OF AMICUS CURIAE

The American Council of Life Insurance ("Council") is a nonprofit voluntary trade association incorporated under the laws of the State of Delaware, the membership

[1] Consents from counsel for the parties have been filed with the Clerk of this Court.

of which totals 636 legal reserve life insurance companies doing business throughout the United States. The member companies of the Council account for 93.9 percent of the legal reserve life insurance in force in the United States and afford protection to 154 million insureds.

Life insurance companies are among the nation's largest direct lenders of mortgage money and purchasers of mortgages on the secondary mortgage market. At the end of 1985, life insurance companies held $171.8 billion in mortgages on U.S. real property, which represented 20.8 percent of the total assets held by life insurance companies in that year.[2]

Due to the long involvement and experience of life insurance companies with real estate mortgages, the Council is uniquely qualified to comment on the language and purpose of the Bankruptcy Code governing the fair and equitable, absolute priority rule as it concerns the real estate mortgagee, and the legitimate expectations of mortgage lenders that the Eighth Circuit's decision would frustrate. The Council offers this *amicus curiae* brief in support of Petitioners, and to explain the adverse and potentially profound economic loss that lenders, life insurance policyholders, the real estate industry and the national economy could suffer if the Eighth Circuit Court of Appeals decision is not reversed.

## STATEMENT

In July 1986, the United States Court of Appeals for the Eighth Circuit in *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986) held that, notwithstanding the requirements of the fair and equitable, absolute priority rule of section 1129(b)(2)(B) of the Bankruptcy Code, a promise by a debtor to contribute labor and expertise in the

[2] American Council of Life Insurance, *1986 Life Insurance Fact Book* 83 (ACLI, Washington, D.C. 1987).



future constitutes a present capital contribution enabling the debtor to retain an interest in property while unsecured creditors remain unpaid, and that entitlement to adequate protection should be postponed for a period equivalent to the time it would take a mortgagee to foreclose free and clear of redemption rights, with payment on the date the debtor anticipated receiving income.

On September 17, 1986, a petition for rehearing was denied for lack of an affirmative vote of an absolute majority of the circuit judges in regular active service, and subsequently a Joint Petition for a Writ of Certiorari to the Supreme Court was filed in December 1986. Several amicus curiae briefs in support of the Joint Petition were filed by interested parties, including the Amicus Curiae Brief of the American Council of Life Insurance.

After requesting and receiving the views of the Solicitor General in an Amicus Brief of the United States filed in May 1987, this Court on June 22, 1987 granted certiorari, but only with respect to the absolute priority portion of the *Ahlers* decision. Consequently, this brief will focus on that issue only.

## SUMMARY OF ARGUMENT

The Eighth Circuit's determinaton that a promise by a debtor to contribute labor and expertise in the future constitutes a present capital contribution enabling the debtor to retain an interest in property, while dissenting, impaired unsecured creditors remain unpaid, is contrary to the express language of section 1129(b)(2)(B) of the Bankruptcy Code and the fair and equitable, absolute priority rule incorporated therein. It is clearly contrary to the intention of Congress, which considered and rejected a proposal by the "Commission on the Bankruptcy Laws of the United States" to permit participation by junior interests based upon promises of future assistance. The determination is also contrary to the language of the case cited by the Eighth Circuit (*Case v. Los Angeles*

*Lumber Products Co.*, 308 U.S. 106 (1939)), which rejected the idea that such intangibles could constitute present contributions of capital.

The Eighth Circuit's decision goes to the heart of one of Chapter 11's fundamental principles—absolute priority—and while *Ahlers* dealt with a farming operation, the holding affects all Chapter 11 cases. The holding in *Ahlers* will have a severe adverse effect upon the insurance industry, which has billions of dollars invested in mortgage loans, as well as other lenders, all of whom are concerned that the bankruptcy laws be administered fairly and equitably.

## I. THE EIGHTH CIRCUIT'S OPINION IN *AHLERS* IS CONTRARY TO THE EXPRESS LANGUAGE OF SECTION 1129(b)(2)(B) OF THE BANKRUPTCY CODE, THE INTENTION OF CONGRESS AND THE DECISIONS OF THIS COURT.

### A. Nothing in the Bankruptcy Code supports the Eighth Circuit's interpretation of the language of section 1129(b)(2)(B) of the Bankruptcy Code, 11 U.S.C. § 1129(b)(2)(B).

The "fair and equitable" or "absolute priority" standard of section 1129(b)(2)(B) of the Bankruptcy Code requires that, with respect to a dissenting impaired class of unsecured claims, the plan must provide that each holder of a claim receive property of a value "equal to the allowed amount of such claim", or no junior claim or interest may "receive or retain under the plan on account of such junior claim or interest *any property*." *Id.* (emphasis added). This provision reads as follows:

> (B) With respect to a class of unsecured claims—
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim;



> or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

Under section 506(a) of the Bankruptcy Code, 11 U.S.C. § 506(a), the claim of an undersecured secured creditor, such as the mortgagees in *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986), is a secured claim to the extent of the value of the collateral and an unsecured claim for the difference between the collateral's value and the amount of the indebtedness.

The Eighth Circuit in *Ahlers* admitted that the plan could not provide property equal to the allowed amount of the mortgagees' unsecured claims as required by section 1129(b)(2)(B). "[W]e agree, that any realistic reorganization plan proposed by the Ahlers could not provide the unsecured creditors with property equal to the amount of their allowed claims. Thus, any feasible plan would not meet the 'fair and equitable' standard of section 1129(b)(2)(B)(i)." 794 F.2d at 401.

Thus the decision below is clearly contrary to the express language of the Bankruptcy Code. The *Ahlers* court nevertheless argues that the plan is subject to an "exception" to the fair and equitable, absolute priority standard, based on a misreading of this Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) as discussed below. Alternatively, the Eighth Circuit argues that the plan meets the "fair and equitable" requirements of section 1129(b) because the equity retained by the debtor under the plan had little value. The Eighth Circuit maintained that the debtor would not realize any "real profit" from the retained equity until the reorganization plan was completed and the allowed amount of the secured claims paid. Therefore, the court concludes unsecured creditors "cannot complain." 794 F.2d at 403. However, the value of what the debtor retains is not germane to 11 U.S.C. § 1129(b)(2)(B).

That section provides that unless the unsecured creditors are fully compensated, junior interests may receive no property. It makes no provision for a differing rule based on the value of what is being retained. *See In re Genesee Cement, Inc.*, 31 Bankr. 442 (Bankr. E.D. Mich. 1983); *In re Huckabee Auto Co.*, 33 Bankr. 132 (Bankr. M.D. Ga. 1981); and *In re Landau Boat Co.*, 13 Bankr. 788 (W.D. Mo. 1981). *Contra In re Star City Rebuilders, Inc.*, 62 Bankr. 983 (Bankr. W.D. Va. 1986).

In addition, the Eighth Circuit argues that the plan was fair and equitable because unsecured creditors would get nothing if the plan were rejected. 794 F.2d at 402. Whether a plan should be rejected by unsecured creditors, however, should be determined by the unsecured creditors when they vote to accept or reject the plan, and not by the court. This Court has held that "[t]he fact that bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan under Section 77B can have no relevant bearing on whether a proposed plan is 'fair and equitable' under that section." *Los Angeles Lumber, supra*, 308 U.S. at 123.

Finally, the Eighth Circuit takes comfort in "the broad rehabilitative purposes of the Bankruptcy Act" [sic] (794 F.2d at 402). The Constitutional requirement that Congress make the laws relating to bankruptcy (U.S. Const. art I, § 8, cl. 4) aside, the court apparently believes that these purposes permit the court to modify the statutory language to keep the Ahlers in business. While the Bankruptcy Code has rehabilitative purposes, "the relevant goal . . . is not that a firm stay in business, but rather that its assets are deployed in a way that, consistent with applicable nonbankruptcy restriction, advances the interests of those who have rights in them." Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 118 (1984). As stated by Judge Gibson in his *Ahlers* dissent, serious policy questions "can best be considered by the Congress. We, however, are advised to confine our efforts to deciding cases on the law as written and on the facts as found." 794 F.2d at 408.



The decision below is clearly in conflict with the express language of the Bankruptcy Code, and should be reversed.

**B. This Court's decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) rejected the Eighth Circuit's argument that a promise by a debtor to contribute labor and expertise in the future constitutes a present contribution of "money or money's worth," entitling the debtor to retain a property interest while unsecured creditors remain unpaid.**

The decision below held that the promise by the debtor to contribute labor, experience and expertise in the future represented a present contribution of money or money's worth entitling the debtor to participate in the reorganization even though dissenting senior creditors would receive less than their allowed claims. The Eighth Circuit based its holding on decisions of this Court which it claimed had "specifically recognized that there may be circumstances in which the absolute priority rule could be modified . . . ." 794 F.2d at 401. Yet this Court and the very case cited by the Eighth Circuit, *Los Angeles Lumber*, rejected the concept that a promise of future labor, experience and expertise could constitute money or money's worth entitling the debtor to such participation.

This Court in *Los Angeles Lumber* dealt with the question of what constituted a new contribution of "money or money's worth" (308 U.S. at 122-23) that would entitle the participant to such an interest and specifically rejected the concept that intangible benefits, having no

place in the asset column of the balance sheet, could be considered a contribution of money's worth. In that case, the District Court, in an *Ahlers*-like holding, had allowed the old stockholders to participate in the reorganized company. *In re Los Angeles Lumber Products Co.*, 24 F. Supp. 501 (S.D. Cal. 1938). The opinion stated that the old stockholders "are the only persons familiar with the company's operations and who have had experience in shipbuilding" (*id.* at 513) and that this, together with the benefit of the stockholders' "business contacts" (*id.* at 513), and "continuity of experience management" (*id.* at 514), constituted a contribution sufficient to allow the stockholders to participate in the reorganized company notwithstanding the fact that senior interests remained uncompensated.

This Court overruled the District Court and the Ninth Circuit Court of Appeals, *In re Los Angeles Lumber Products Co.*, 100 F.2d 963 (9th Cir. 1939), on that very point saying that such items were illustrative of "a host of intangibles which, if recognized as adequate consideration . . . would serve as easy evasions of the principle of full or absolute priority . . . . They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities." 308 U.S. at 122-23 (footnotes omitted). Obviously, a debtor's unenforceable promise to work hard in the future, contributing "experience, knowledge and labor", would have no place in the asset column of a balance sheet and thus the decision below reflects the same "vague hopes or possibilities" the very decision of this Court cited by the Eighth Circuit rejected.

Indeed, it is often the inexperience, lack of expertise and carelessness of the debtor that causes the debtor's financial plight. Even in the worst of economic circumstances, those individuals and enterprises that fail are often the less efficient and least capable, especially in connection with their individual service and performance



contributions to the business. It is inconceivable that a debtor's promise to continue what may have been inadequate performance should be the basis for denying senior interests their right to absolute priority. *See* Brudney, *The Bankruptcy Commission's Proposed "Modification" of the Absolute Priority Rule*, 48 Am. Bankr. L. J. 305, 337 (1974) where the author states that "there is little or no basis for issuing new participations for vague hopes, especially in a proceeding in which there is no guaranty of an independent assessment of the role of old management or controlling stockholders . . . in bringing the enterprise to insolvency."

### C. The Eighth Circuit's subversion of the fair and equitable requirement is contrary to the intent of, and was rejected by Congress.

In drafting the Bankruptcy Code, Congress specifically considered a proposal for changing the fair and equitable or absolute priority rule in a manner similar to the Eighth Circuit's holding in *Ahlers*, and rejected it. The initial proposed bankruptcy bill contained a provision that would have, like *Ahlers*, permitted expertise, promised management and the like to justify participation in the plan by equity owners while creditors remained unpaid. Congress, however, refused to accept the proposal and instead adopted the fair and equitable, absolute priority rule.

On July 24, 1970, then President Nixon appointed the Commission on the Bankruptcy Laws of the United States ("Commission") to consider a review of the Bankruptcy Act. The Commission completed its work in July 1973 after an extensive study and submitted its Report ("Commission Report") containing a proposed new bankruptcy law ("Commission Bill"), which was submitted to Congress in 1973. H.R. Doc. No. 137, Parts I and II, 93d Cong., 1st Sess. (1973). The Commission Report represented a major step toward the eventual adoption of the Bankruptcy Code.

The Commission Report discussed the nature, development, justification and deficiencies of the absolute priority rule, noting that it had become a "straight jacket" since under it, unless all unsecured claims were paid in full, equity security holders could not participate even by agreement of all the classes of creditors. Commission Report, Part I, at 256-57. This deficiency has been overcome in the Bankruptcy Code as enacted by limiting absolute priority to dissenting impaired classes. The Commission, however, had suggested another solution. It recommended that "the fairness test be modified . . . by allowing equity security interests to participate if their future contributions, e.g., continued management, are essential to the business." Commission Report, Part I at 258.

The Commission Bill, in Section 7-303(4) provided that a plan of reorganization:

> may provide, if the court finds that, (A) in the case of a partnership debtor, when the partners retain an interest under the plan, (B) in the case of an individual, when he retains an interest under the plan, and (C) in the case of a corporate debtor, when the equity security holders retain an interest under the plan, the individual debtor, certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution.

This proposed modification of the absolute priority rule created a storm of controversy. *See* Brudney, *supra* p. 9, at 337 [3] where the author stated:

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[3] *See also* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule of Corporate Reorganizations*, 87 Harv. L. Rev. 1786, 1817 (1974).



> The Commission apparently thinks that the 'business contacts . . . with financial institutions . . . and . . . customers' which the District Court found in the *Los Angeles Lumber Products Co.* case were to be contributed by 'stockholders of financial influence and stability' are important enough to justify the issuance of new stock to them. But the Commission's mere ipse dixit offers no answer to the Supreme Court's response that those kinds of 'vague hopes or possibilities' were too 'ephemeral' to be valued and would simply 'serve as easy evasions of the principle of full or absolute priority. . . .'

The Commission proposal was rejected by Congress. In its place Congress inserted the unambiguous absolute priority rule of 11 U.S.C. § 1129(b)(2)(B):

> The general principle of [section 1129(b)] . . . permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 413, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6369.

In choosing to read into the Bankruptcy Code the rejected Commission proposal, the Eighth Circuit has usurped the legislative power of the Congress.

Indeed, a major purpose of providing for the section 1111(b) conversion of a non-recourse claim to a recourse claim and then providing absolute priority for the unsecured class under section 1129(b)(2)(B), was to overrule cases under Chapter XII of the former Bankruptcy Act, such as *In re Pine Gate Assoc., Ltd.*, 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976), under which the non-recourse mortgagee was paid the value of the collateral while the debtor kept the property.

*Ahlers* would produce a result similar to, but even more burdensome than that which Congress intended to

avoid (*Pine Gate* dealt only with non-recourse debt while *Ahlers* would apply to both recourse and non-recourse debt, and *Pine Gate* provided that the mortgagee receive the collateral value in cash, rather than a mortgage with a face amount equal to the value of the collateral as in *Ahlers*) and is obviously contrary to the intent of Congress. *See, e.g.*, Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. Law. 441 (1984); L. Cherkis, *Collier Real Estate Transactions and the Bankruptcy Code* § 1.11 (King ed. 1985), and S. Rep. No. 989, 95th Cong., 2d Sess. 65, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5851 (commenting on section 502(i), an earlier version of 11 U.S.C. § 1129(b)).[4]

Thus it would seem clear that Congress specifically intended the unambiguous call for absolute priority found in section 1111(b) of the Bankruptcy Code. Last year Congress reaffirmed the absolute priority requirement of Chapter 11 by the enactment, as part of the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, of a new Chapter 12 to the Bankruptcy Code on October 3, 1986. H.R. 5316, 99th Cong., 2d Sess. (1986). Chapter 12 deals with an emergency condition faced by certain "family farmers" as defined therein, and will expire at the end of seven years if not renewed. *See* sections 251 and 302(f) of Chapter 12. Chapter 12 provides for a modification of the absolute priority rule by permitting the court to limit the recovery of the mortgagee on its unsecured claim to the amounts unsecured creditors would receive if there had been a Chapter 7 liquidation. Since, under current conditions in the farm belt, it is unlikely that unsecured creditors will receive payments under the plan, the result to the debtor under Chapter 12 will be similar to

[4] See the more complete discussion of this Congressional purpose in the Brief Amicus Curiae of the American College of Real Estate Lawyers.



*Ahlers* in that the debtor will be able to keep the property with the mortgagee relegated to a mortgage with a principal balance equal to the value of property. If the *Ahlers* interpretation of absolute priority (which would apply to all debtors under Chapter 11) were correct, there would have been no necessity to enact Chapter 12 for family farmers. Indeed, the inability of the family farmer to satisfy the unsecured claim under 11 U.S.C. § 1129(b)(2)(B) was the *raison d'etre* for Chapter 12. *See* 132 Cong. Rec. S15075 (daily ed. Oct. 3, 1986) (statement of Senator Grassley).

• • • •

In summary, the *Ahlers* decision is contrary to the language of Chapter 11, the intent of Congress and the case it cites for support of its conclusions. It should be reversed.

## II. THE EIGHTH CIRCUIT'S DECISION IN *AHLERS* APPLIES TO ALL CHAPTER 11 CASES AND IF ALLOWED TO STAND WOULD SEVERELY AND NEGATIVELY IMPACT BOTH BORROWERS AND LENDERS AND WOULD ENCOURAGE FURTHER FEDERAL COURT DECISIONS THAT IGNORE BOTH THE LANGUAGE AND INTENT OF CONGRESS.

### A. The *Ahlers* misconstruction of Chapter 11 of the Bankruptcy Code applies to all cases under that Chapter and is not limited to insolvencies of farmers.

While *Ahlers* involved a farmer, and the present plight of farmers may have been a motivating factor in the Eighth Circuit's desire to enable the debtor to keep the farm, it is clear that the rules and principles laid down by the Eighth Circuit apply with fine impartiality to all cases under Chapter 11.

Thus, if *Ahlers* is not reversed, the real estate developer in Chapter 11, whose mismanagement may have been the cause of the failure, can keep the property by promising to continue the past inadequacies, while the mortgagee's unsecured claim remains unpaid. Real estate partnerships can, by filing in Chapter 11, effectively reduce their mortgages to the value of the collateral while continuing to operate the property.

Additionally, corporations in Chapter 11 can propose, and have confirmed, plans under which old stockholders, by promising to provide the reorganized company with continuity of management, their business contacts, their stature and influence in the financial community, or a "host" of other "intangibles," obtain an interest in the reorganized company without compensating a dissenting unsecured creditor class, and easily evade "the principle of full or absolute priority" mandated by the Bankruptcy Code and this Court's decision in *Los Angeles Lumber*.

**B. The insurance industry with over $170 billion invested in mortgage loans, and over 150 million policyholders, as well as other lenders relying on legitimate expectations in connection with mortgage investments, and borrowers seeking financing will be severely and negatively impacted by *Ahlers*.**

The insurance industry has invested over $170 billion of the funds of over 150 million policyholders, pension customers and others in real estate mortgages, based on the reasonable expectation that the collateral will be available to satisfy the mortgage indebtedness when and if the borrower is unable to pay the debt service. Legal reserve life insurers have in force some 391,000,000 policies.[5] Each of them is a promise to the policyholder to pay certain benefits. The ability of an insurer to fulfill

[5] American Council of Life Insurance, 1987 Life Insurance Fact Book 9 (ACLI, Washington, D.C.) (expected publication date October 1987).



its obligations under agreements with its policyholders is directly affected by its ability to enforce its loan agreements. Notwithstanding this, the insurance industry and other lenders recognize that in bankruptcy reorganizations they may not be able to realize on the collateral directly, but understand that in such event, they could be protected by a reorganization plan that would be fair and equitable, affording absolute priority to both their secured and unsecured claims. Had it not been for those reasonable expectations, many of the loans would not have been made, and those that might have been made would most probably have been only at higher interest rates and to borrowers of the highest credit standing. *See* Baird & Jackson, *supra* pp. 6-7, at 112.

If the *Ahlers* result should be sustained, it would cause a reduction in the quality of the mortage portfolio of every lender, result in what might be significant losses, and subject borrowers to stricter credit tests and higher interest rates. Traditionally real estate and other property have been able to serve as the basis for raising funds by those borrowers without adequate credit standing. With these funds they have built major developments and new businesses, creating new jobs and expanding the nation's economy. It is for those borrowers as well as the lenders that the policy decisions were made resulting in the cramdown language of the Bankruptcy Code, which language is being attacked by the *Ahlers* decision. It is those borrowers who would be most hurt by the decision below, a decision which, if not reversed, can only have an adverse and abiding negative impact on the national economy and the spirit of entrepreneurship upon which this country was built.

**C. The decision below represents a gross overreaching by the Eighth Circuit to modify Congressional language and purpose.**

The Eighth Circuit's decision in *Ahlers* represents such an egregious attempt to change a Federal statute by

judicial decision that the Solicitor General, in his earlier *amicus curiae* brief submitted in connection with the granting of certiorari, was moved to urge this Court to consider summary reversal on the issue here argued. "If the approach to absolute priority taken by the Court of Appeals in this case were to proliferate, the debtor-creditor relationship would be fundamentally and unjustifiably altered. On this issue, the Court may wish to consider summary reversal." Brief at 10.

The magnitude of the deliberate judicial misconstruction of the Bankruptcy Code represents a gauntlet thrown down before this Court, a challenge to the integrity of our system of separation of powers. The decision must be overturned.

## CONCLUSION

The judgment of the Court of Appeals should be reversed.

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# BRIEF

Supreme Court, U.S.
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No. 86-958

In The
# Supreme Court of the United States
October Term, 1987

NORWEST BANK WORTHINGTON AND
FEDERAL LAND BANK OF ST. PAUL,

*Petitioners,*

v.

JAMES R. AHLERS AND MARY M. AHLERS,

*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## BRIEF OF THE STATES OF ARKANSAS, CONNECTICUT, IOWA, ILLINOIS, KENTUCKY, MINNESOTA, MONTANA, NEBRASKA, NEW YORK, NORTH DAKOTA, SOUTH CAROLINA, SOUTH DAKOTA AND TEXAS AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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## QUESTION PRESENTED

May an individual debtor retain ownership of a reorganized business under the provisions of Chapter 11 of the Bankruptcy Code based upon a new contribution of essential labor and management skills despite the objection of creditors?

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## STATEMENT OF INTEREST

The issues in the present case are raised in the context of a national crisis in agriculture. As of January, 1987, over forty-six percent of all United States farms were experiencing a negative or zero cash flow. Economic Research Service, U.S. Department of Agriculture, Agric. Info. Bull. No. 525, *Financial Characteristics of U.S. Farms,* January 1, 1987, 11. Farm real estate values fell by $80 billion in 1985 and $44.2 billion in 1986. *Id.* at 3. Nationwide, over 70,000 farms were lost in 1986 alone. Minnesota Agricultural Statistics Service, *Minnesota Agriculture Statistics 1987,* July, 1987, 6. Accordingly, the issues before the court in the present case are of considerable public importance.

Each of the amici states has a citizenry substantially affected by the agricultural economy. For example, in Minnesota, farming and farm-related industries constitute approximately twenty-five percent of that state's economic base, with nineteen percent of Minnesota's jobs directly or indirectly related to farming. Interview with Professor Wilbur R. Maki, Department of Agricultural and Applied Economics, University of Minnesota (May 2, 1986). In each of the amici states, agriculture is a substantial industry that forms both an integral part of that state's economy and social fabric.

Because of the importance of agriculture in the amici states, the problems which presently plague rural citizens are a major public concern. Not only are farms and farm families at risk, all of rural society as it now exists is threatened. As Professor Neil E. Harl has stated:

> Unless something dramatic is done or circumstances change, more than one-third of the farmers nationally will move to insolvency within three to four years, taking down their lenders, their suppliers, and other merchants and inflicting incalculable damage upon the fabric of rural communities. Discharged indebtedness will ricochet through local communities, with the unsecured creditors taking the greatest hit.

Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 Kan. L. Rev. 425, 430 (1986).

In response to this situation, the states have considered various forms of farm debt-relief statutes. In Minnesota, for example, the legislature passed such legislation based upon the following findings:

> The legislature finds that the agricultural sector of the state's economy is under severe financial stress due to low farm commodity prices, continued high interest rates, and reduced net farm income. The suffering agricultural economy adversely affects economic conditions for all other businesses in rural communities as well. Thousands of this state's farmers are unable to meet current payments of interest and principal payable on mortgages and other loan and land contracts and are threatened with the loss of their farmland, equipment, crops, and livestock through mortgage and lien foreclosures, cancellation of contracts for deed, and other collection actions. The agricultural economic emergency requires an orderly process with state assistance to adjust agricultural indebtedness to prevent civil unrest and to preserve the general welfare and fiscal integrity of the state.

Minn. Stat. § 583.21 (1986).

In addition to the relief that the states have attempted to provide for their rural citizenry, many farms and rural businesses have turned to Chapter 11 of the Bankruptcy



Code in an effort to resolve their financial distress. It is in this context that the present debtors, Mr. and Mrs. Ahlers, seek reorganization of their family farm enterprise. The issues addressed in their case concern not only whether such reorganizations will be available to them, but whether such reorganizations will be available for thousands of others like them throughout the amici states. According to the interpretation of the Bankruptcy Code espoused by Petitioners, such reorganizations would be effectively eliminated. Under the guidelines set forth in the decision of the Eighth Circuit Court of Appeals of July 2, 1986, the Respondents and similarly situated farm operators would be afforded the opportunities for reorganization intended by Congress when it enacted the Bankruptcy Reform Act of 1978. For these reasons, the amici states respectfully offer this brief in support of the Respondents.

———o———

## SUMMARY OF ARGUMENT

The absolute priority rule, as developed by this Court, has long recognized that former owners of a financially distressed business may retain ownership of the reorganized business under a Plan of Reorganization through a contribution of new value despite the dissent of a class of creditors even if such creditors are not paid in full. Nothing in the legislative history of the Bankruptcy Code indicates a clear congressional intent to abrogate this new value rule. Rather, this rule is consistent with the provisions of Chapter 11 and operates so as to not unfairly discriminate against former owners of the business.

An individual's contribution of essential labor and management skills satisfies the new value rule as developed by this Court and as incorporated into the provisions of the Bankruptcy Code. Such contributions have real economic value which may be determined by a court in assessing whether such contributions are substantial and in proportion to the retained interest of the former owners of the business. In addition, under the provisions of the Bankruptcy Code, contributions of labor represent new consideration contributed to the business by the former owners. Recognizing them as new value is in accord with fundamental policies of the Bankrutpcy Code which foster and protect individual debtors. Failure to recognize the contributions as new value destroys the balancing of interests contemplated by Congress in the enactment of Chapter 11 and renders the relief provided by Chapter 11 for farms and small businesses meaningless.

———o———

## ARGUMENT

### CHAPTER 11 ALLOWS CONFIRMATION OF A PLAN OF REORGANIZATION UNDER WHICH AN INDIVIDUAL DEBTOR WILL RETAIN CONTROL OF THE BUSINESS ASSETS OVER THE DISSENT OF UNSECURED CREDITORS.

A plan of reorganization under Chapter 11 of the Bankruptcy Code may be approved by a court over the objection of a class of creditors if it is "fair and equitable," even if the dissenting creditors are not paid in full. However, under the "absolute priority rule" of § 1129(b)(2), no equity owners may receive anything under the plan



on account of their pre-bankruptcy ownership unless dissenting creditors are paid in full.[1]

This section does not prohibit former owners from participating in the reorganized business if they contribute new value to the business under the reorganization plan. This Court has repeatedly recognized that, under the Bankruptcy Act, former owners were not disqualified from participating in the reorganization solely on account of their prior relationship with the debtor. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913). The new value rule at issue in this case is thus a rule designed to treat former owners fairly, rather than a rule discriminating in favor of such owners. Owners who contribute new value do not retain ownership "on account of" their prior interest. Rather, the source of their new interest in the reorganized business is their new contribution.

---

[1]The statutory language at issue is critical. Section 1129(b), as it relates to a class of unsecured creditors, provides as follows:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (B) With respect to class of unsecured claims:
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan *on account of such junior claim or interest* any property. 11 U.S.C. § 1129(b) (emphasis added).

This new value concept has been recognized by this Court despite the absence of any explicit statutory basis for the rule. Rather, the new value rule has been developed by this Court to recognize the realities of bankruptcy reorganization, namely, that new value is sometimes required in order to successfully reorganize and that former owners may be the most feasible source of such contributions. *Los Angeles*, 308 U.S. at 121 n.15.

### A. THE NEW VALUE RULE OF CASE v. LOS ANGELES LUMBER PRODUCTS CO. IS EMBODIED IN § 1129(b)(2) OF THE BANKRUPTCY CODE.

The absolute priority rule was developed in cases involving publicly held corporations. *Consolidated Rock Products v. DuBois*, 312 U.S. 510 (1941); *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913); *Louisville Trust Co. v. Louisville Railway Co.*, 174 U.S. 674 (1899). The rule was developed to prevent stockholders of an insolvent corporation from participating in a reorganization while some creditors remained unpaid. This could be done by having the corporation put itself into a "friendly" receivership, under an agreement with major creditors that stockholders would participate in the reorganized corporation. The major creditors, able to bid their claims instead of cash, were usually able to purchase at a low price. Frequently, there would be little or nothing left for distribution to general creditors. The shareholders of the old corporation would, therefore, become shareholders of the new corporation, which was free of all the old debt. See *6 Collier on Bankruptcy*, para. 0.04 (14th Ed. 1978). In public corporations, ownership is merely a financial



investment. In such cases, the creditors have a right to protection of their priority position.

However, application of the rule to small businesses, especially farming operations, has long been subject to criticism since its application may effectively prohibit reorganizations of such businesses and farms. *See, e.g.*, Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine*, 45 Colum. L. Rev. 739, 741 n.8 (1945). More importantly, Congress rejected the rule entirely when, in 1952, the Bankruptcy Act was amended to expressly allow the retention of an interest by a debtor or a debtor's shareholders in cases involving small businesses. 66 Stat. 433, §§ 35, 43, 50 (1952). In clearly expressing its intent, the House Committee Report indicates:

> [T]he fair and equitable rule, as interpreted in *Northern Pacific Railway Co. v. Boyd*, . . . and reaffirmed in *Case v. Los Angeles Lumber Products Co., Ltd.*, . . . cannot be realistically applied in a Chapter XI, XII, or XIII proceeding. Were it so applied, no individual debtor, and under Chapter XI, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payments of the claims of all creditors in full. The proposed amendment is designed to remove the fair and equitable provision, and by the paragraph added to each of the amended sections, it is made clear that the rule of the *Boyd* and *Los Angeles* cases shall not be operative under those three chapters.

H.R. Rep. No. 2320, 82nd Cong., 2nd Sess. 2, *reprinted in* 1952 U.S. Code Cong. & Ad. News, 1981-1982.

Since enactment of the Bankruptcy Code in 1978, lower courts have questioned or criticized the effect of the rule

as it applies to small businesses, *In re Star City Rebuilders, Inc.*, 62 Bankr. 983, 988 (Bankr. W.D. Va. 1986), and family farmers, *In re Witt*, 60 Bankr. 556, 560 (Bankr. N.D. Iowa 1986); and *In re Stegall*, 64 Bankr. 296, 301 (Bankr. C.D. Ill. 1986). Such courts have observed the same difficulty with the rule that was addressed and eliminated by Congress in 1952. Rigid application of the absolute priority rule in cases of small businesses would make reorganization of such businesses under Chapter 11 of the Bankruptcy Code extremely difficult. Reorganization of businesses are the fundamental goal of Chapter 11. *See, e.g., Witt*, 60 Bankr. at 560.

Petitioners and their supporters contend, despite the criticism of the absolute priority rule and the long history of the new value rule, that § 1129(b)(2) does not incorporate the new value concept. For support, Petitioners cite no legislative history, but rely simply on a proposal by the Bankruptcy Commission permitting retained ownership if the former owner's contribution to the business was "important" (Brief of Petitioners, pp. 16-18). According to Petitioners, rejection of this proposal by Congress evidences an intent to overrule *Los Angeles*. However, while § 1129(b)(2) does not, by its express terms, address the new value concept, it does not, likewise, reject it. Rather, Congress chose to use the term "fair and equitable" to define plan confirmation standards. This is precisely the same term of art recognized by this Court in *Los Angeles*, to include the new value rule of earlier cases. *Los Angeles*, 308 U.S. at 117. The term has had the same meaning since at least 1939. Congress has not redefined it.



Petitioners argue in effect that Congressional silence justifies an even more stringent standard of absolute priority for individuals and small businesses than was presented by the Bankruptcy Act prior to 1978. Such an argument is incongruous in light of § 1129(a)(8) which liberalized the traditional absolute priority rule by allowing any senior class of creditors to "give up value" to a junior class including owners, in order to facilitate a reorganization. In addressing the liberalized rule, the House Report indicated a clear intent to codify "the absolute priority rule from the dissenting class on down." H.R. Rep. No. 595, 95th Cong., 1st Sess. 412 (1977). Congress did not indicate it was adopting only a portion of the absolute priority rule.

In addition to the total lack of any legislative history to support the position of Petitioners, the Bankruptcy Code clearly and unambiguously allows for contributions of new value by third parties. A plan of reorganization may create new ownership through transfers of property to other entities (11 U.S.C. § 1123(a)(5)(B)), sales of property (11 U.S.C. § 1123(a)(5)(D)), or the issuance of securities (11 U.S.C. § 1123(a)(5)(J)). The Code is silent on the question of who may be a transferee, purchaser or holder of a security under these provisions. But there is clearly no express restriction on a former owner reacquiring an ownership interest under such plan provisions.

Finally, contrary to the assertions of the Solicitor General, the existing case law since 1978 has unanimously accepted the new value rule. (Brief of the United States, p. 17, n.15). While owners cannot retain control and ownership of the business simply because of their prior own-

ership, they can retain ownership by making a new capital contribution that is substantial and necessary to the reorganization. *In re U.S. Truck Co.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material Services, Inc.*, 781 F.2d 99 (7th Cir. 1986); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454 (Bankr. C.D. Ill. 1987); *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981); *In re Marston Enterprises*, 13 Bankr. 514 (Bankr. E.D. N.Y. 1981). No court or respected commentator has, until this case, questioned the survival of the new value rule.

In summary, no legislative intent to overrule *Los Angeles* can be cited by Petitioners or their supporters. Moreover, the same practical necessities recognized by this Court in *Los Angeles* are presented in reorganizations under Chapter 11. Absent clear and convincing guidance to the contrary, this Court should interpret Chapter 11 in light of prior treatment of small business debtors. While the owner cannot retain ownership on account of his prior interest, he cannot be prevented from obtaining ownership through a contribution of new value.

### B. AN OWNER'S CONTRIBUTION OF ESSENTIAL LABOR AND MANAGEMENT SKILLS TO A REORGANIZED BUSINESS CONSTITUTES A CONTRIBUTION OF NEW VALUE TO THE ENTERPRISE.

#### 1. A Contribution of Essential Labor and Management Skills is a New Investment by the Owner in the Reorganized Business.

The basic standards for new value contributions are stated in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 108 (1939). The new contribution must be "necessary" to the reorganization and the value of the retained ownership must be "reasonably equivalent" to the value of the new contribution. *Id.* at 121. However, it has never been a requirement that the new contribution be made in cash. In *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), this Court recognized that "practical considerations" intervene in such cases so as to not "require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company." *Id.* at 508. Rather, *Boyd* recognized that a shareholder's interest can be preserved by the issuance of "income bonds or preferred stock." *Id.* at 508.



Mindful of these practical considerations, courts have been willing to treat promises and contingent financial support as new value. In *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981), for example, seventy-five percent of the new value recognized by the court was in a promise (commitment) to make a loan in the future. In *In re Potter Material Services, Inc.*, 781 F.2d 99 (7th Cir. 1986), the sole shareholder of the corporate debtor agreed to personally guarantee a loan to the reorganized company. The Seventh Circuit Court of Appeals held that "such a guarantee, even though the debt was fully secured by business assets, was an economic risk of indeterminable value" and hence new value. *Id.* at 103. Finally, in *In re Brown's Industrial Uniforms, Inc.*, 58 Bankr. 139 (Bankr. N.D. Ill. 1985), the shareholder contributed new value by a pledge of his personal assets as security for a loan to the company.

While some debtors may have sources of new cash, the family farm frequently contains substantially all of

the assets of the individual debtor. In the case at bar, all of the debtors' farm land is subject to the mortgage of the Federal Land Bank of St. Paul (Pet. App. A-3). All farm machinery and equipment, crops, livestock, and other farm products, together with a second mortgage on all farmland, is subject to the lien of Norwest Bank Worthington (Pet. App. A-4). Non-farm businesses are often similarly situated. As a result, in such cases, all cash and the debtors' personal credit are inextricably linked to the income of the business. It is nearly impossible for such debtors to contribute new cash to the business enterprise. Rather, the new value in such a case must be contributed in kind, rather than in cash.

While such contributions are not as liquid as cash, they are, in fact, a means of exchange. And while capital may be easily dissipated, labor may not. While the value of capital may be fixed, the value of the skills of a specialized business operator, such as a farmer, may be similarly measurable. While the value of such skills may be speculative, it is no more speculative than the value of a promise of a guarantor to pay a debt several years hence, or the going concern value of an ongoing operation. In short, the management skills and labor of a farmer or other small business person have an economic value that is measurable and that is real.

Recognition of the value of such services is not revolutionary but, rather, is firmly grounded in the Bankruptcy Code. For while the proceeds of the assets of a business are property of the estate and available for payment of creditors, earnings from a debtor's post-petition personal services are not. *In re Fitzsimmons*, 725 F.2d 1208 (9th



Cir. 1984); 11 U.S.C. § 541(a)(6). Under the Bankruptcy Code, an individual may leave the business and apply his personal efforts to other income-earning opportunities, free of creditor claims. By choosing to stay with the business, the debtor demonstrates an effort to pay prior creditors that, with appropriate safeguards, represents a contribution of value which the creditors could not otherwise access. By contributing the value of such services, the owner places new assets at risk for the benefit of creditors, and should be entitled to receive in return the benefits of ownership. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L. Rev. — (To Be Published 1987).

This is not to say, however, that every sole proprietor, general partner, or shareholder who agrees to use his best efforts in the continued operation of the business, is entitled to retain his ownership interest. Such a rule would go too far. Rather, only if the individual's contribution has substance and value in relationship to what he retains should the individual be allowed to retain ownership under the decision below. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 108, 121. Under the decision below, the court must "require that any cashflow from the operation of the farm in excess of that anticipated in the plan should be paid to the unsecured creditors" until the unsecured debt is fully paid (Pet. App. A-27). Anticipated income is thus to be used to make payments under the plan and to support the family. Excess or unanticipated income must be given to lenders, rather than retained for the benefit of the owner. The individual retains ownership, but only so far as his efforts contribute to pay creditors.

Similarly, the decision below allocates property valuation risk to reduce the potential profit for debtors. Ordinarily, the owners of property benefit from any sale of property in excess of the amount needed to pay reorganized debt. The Court of Appeals held, however, that the equity position of the "owner" should be calibrated to the actual contribution he has made at any point until the plan is completed or the creditor paid in full (Pet. App. A-27). In effect, this creates a joint venture between the holders of unsecured claims and the individual debtor, not unlike the income bonds or preferred stock approved by this Court in *Boyd*, 228 U.S. 482, 508.

Thus, the decision below results in restricting the creditors' risks and the debtor's potential gain. In effect, by creating a risk and reducing windfall gains for the debtor, the decision tends to restrict use of the rule to only those cases where the individual is actually willing to make an effort and a sacrifice to pay creditors by operating the business. As a consequence, the rule adopted by the Court of Appeals is and should remain a special application, rather than an easily available alternative.[2]

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[2]In contrast, Congress has recently enacted such a general rule by eliminating the absolute priority rule entirely from Chapter 12. Under a Chapter 12 Plan of Reorganization, a family farm debtor need only agree to use his "disposable income" for the payment of unsecured creditors during the term of the plan in order to retain all of his property, provided other requirements for plan confirmation are met. 11 U.S.C. § 1225(b)(1)(B). However, Chapter 12 is only available for "family farmers" as defined in 11 U.S.C. § 101(17). In the case of an individual, this requires the debtor to meet an income eligibility test as well as a debt structure test. Not all farmers can fit the definition of a "family farmer." Moreover, nonfarm business operations can only look to Chapter 13 as a reorganization alternative. Chapter 13 is limited to individuals with severely restricted debt limitations. 11 U.S.C. § 109(e).



Such a special application is not unprecedented. In *Horowitz v. Kaplan*, 193 F.2d 64 (1st Cir. 1951), *cert. denied*, 342 U.S. 946 (1952), the First Circuit Court of Appeals upheld the confirmation of a plan of reorganization under Chapter X of the Bankruptcy Act which allowed the management to eventually acquire thirty-two percent of the common stock of the corporate debtor. The management involved in the case had previously brought the debtor through two prior reorganizations. The plan was challenged by certain other shareholders as being in contravention of the absolute priority rule. In responding to such contentions, the court rejected the argument that *Los Angeles* established a rigid rule which prohibited such reorganizations. In addition, the Court of Appeals distinguished *Los Angeles* because the record in *Los Angeles* did not show important contributions by management, and the participation included stockholders who were not part of management. 193 F.2d at 74.

Such a special application is not contrary to the rule of *Case v. Los Angeles Lumber Products Co.* There the court simply noted that, *on the facts presented*, the retention of current owners was insufficient to be "translated into money's worth reasonably equivalent to the participation accorded the old stockholders." 308 U.S. at 122. As Justice Douglas emphasized, not all the former owners who would participate in the reorganized business were part of the debtor's management. 308 U.S. at 123 n.17. Indeed, many would contribute nothing new at all. Nothing in *Los Angeles* stands for the proposition that the contribution of essential labor and management skills is an insufficient contribution of new value as a matter of law to warrant continued participation in the reorganized business. Indeed, in *Securities and Exchange Commission v.*

*U.S. Realty and Improvement Co.*, 310 U.S. 434 (1939), this Court suggested that in situations involving small businesses, where the junior interests are held by the management of the business, "the going concern value through their continued management of the business may compensate for reduction of the claims of the prior creditors without alteration of the management's interests, which would otherwise be required by the *Boyd* case." 310 U.S. at 454.

### 2. Recognizing a Contribution of Essential Labor and Management Skills as New Value Furthers Bankruptcy Policy to Protect Individual Debtors who deal fairly with their Creditors and Make a Good Faith Effort to pay their Debts.

The conflicting positions in this case present diametric views of the role of bankruptcy law and require this Court to deal with fundamental questions of direction and purpose, rather than mere technical interpretations of the Bankruptcy Code. The Court's decision will seriously affect the ability of family or individually owned farms and small businesses to survive economic distress through bankruptcy reorganization.

Petitioners and their supporters apparently regard bankruptcy as no more than a federal, structured collection system.[3] They claim that the sole owner loses all of his

[3]For example, at page 13, the Brief for the United States as Amicus Curiae quotes with approval the following language from an article: "Reorganization proceedings provide nothing more than a method by which the sale of an enterprise as a going concern may be made to the creditors themselves." Citing Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 Yale L.J. 857 (1982). Similarly, the brief of the American Council of Life Insurance claims that the relevant goal is that the debtor's assets are deployed to the advantage of those who have an interest in them. Brief of the American Council of Life Insurance, p. 6.



interest in his company when insolvency occurs.[4] They assert that the owner's rights are entirely subordinate to creditors and that any protection of the individual places unwarranted loss on creditors (See, Petitioner's Brief, p. 23 and Brief of the United States, pp. 12-13). Bankruptcy in this view becomes a one way street. It lacks any balance and leads to a destination where the individual and his family inevitably lose their farm, their business, and, in cases such as the one at bar, their home.

To the contrary, Congress intended in the Bankruptcy Code to balance interests and allocate the losses caused by a debtor's insolvency. M. Bienenstock, *Bankruptcy Reorganization* 3 (1987) ("strike a balance between supporting a troubled company's efforts . . . and limiting the concomittant adverse effects . . ."); Nimmer, *Negotiated Reorganization Plans, supra.* ("The primary objective of bankruptcy is loss allocation").

The loss allocation functions of bankruptcy permeate the Bankruptcy Code and are repeatedly referred to in its legislative history.[5] For example, secured creditors who

[4]As defined in the Code, insolvency is a current financial condition in which current assets are inadequate to pay liabilities. 11 U.S.C. § 101(31). Petitioner and the United States, in their briefs seeking repeal of the new value rule attach mystical significance to this limited and often uncertain factual issue. The brief for the United States notes: "when its debts exceed the present value of its assets, all of its assets are properly treated as owned by the creditors." Brief of the United States at 12-13.

[5]*See, e.g.*, "Reorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by a unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders." S. Rep. No. 989, 95th Cong., 2nd Sess. 11, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5796.

hold an absolute right to foreclosure are stayed in order to permit the debtor's use of property, but the stay continues only so long as the creditor's interests are adequately protected. 11 U.S.C. § 362. Chapter 11 plans require voted acceptance by a majority of creditors and dissenters are bound by the plan, but only so long as they receive more than they would have received in a liquidation. 11 U.S.C. § 1129(a)(7). Individuals, but not corporations or partnerships, are discharged in Chapter 7 from most debts, but discharge is denied if they acted fraudulently. 11 U.S.C. § 727. Individuals who commit future income to pay creditors in Chapter 13 receive an even broader discharge in return for their good faith efforts at repaying their creditors. 11 U.S.C. § 1328.

Loss allocation under the Bankruptcy Code even extends to eliminating interests in property in furtherance of the debtor's exemptions, discharge and fresh start. Under § 522(f), debtors may avoid judicial liens and certain nonpurchase-money, nonpossessory liens to the extent such liens, even though valid, impair an exemption. *United States v. Security Industrial Bank*, 459 U.S. 70 (1982).

These protections for individuals indicate a balance of interests in which the individual debtor does not relinquish all rights. Instead, the interests of some creditors are sacrificed to protect substantial interests of the debtor. Such protections spread some of the loss of insolvency, rather than concentrating the loss on an individual and his family. Recognizing an individual's contribution of essential labor and management skills as new value is consistent with this congressional policy of individual protection.



This result, however, does not occur automatically and inevitably. Bankruptcy policy as included in the Bankruptcy Code makes various assumptions about the individual's behavior vis-a-vis his creditors and his ability to pay debts in full. If the debtor is unable to pay creditors in full and treated creditors fairly, concerns about individual welfare lead us to protect him. If these assumptions are not met, however, a discharge may be denied. Nimmer, *Consumer Bankruptcy Abuse*, 50 Law & Contemp. Pblm. 89 (1987); Resnick, *Prudent Planning or Fraudulent Transfer? The Use of Non-exempt Assets to Purchase Exempt Property on the Eve of Bankruptcy*, 31 Rutgers L. Rev. 615 (1978).

Assuming that the debtor acts in good faith, he generally obtains his discharge. This creates the "fresh start" for which bankruptcy was designed and is at the heart of the Bankruptcy Code. H.R. Rep. No. 595, 95th Cong., 1st Sess. 384 (1977). The discharge gives the debtor an unencumbered right to his future income even though valid debts are unpaid. The result of a discharge is that the individual is excused from any legal obligation to use future income or assets to pay prior debts. 11 U.S.C. § 524. The creditors suffer some loss because they can no longer reach these assets for collection, while the individual obtains relief from harassment and retains potentially significant value.

Here, the absolute priority rule that the Petitioners argue for involves unsecured creditors who have no property interest in the debtor's assets. Nevertheless, Petitioners claim that their unsecured interest overrides *any* protection for the owner of the business. But other pro-

visions of bankruptcy law do not support such a result. Instead, they establish loss-sharing and protection under bankruptcy rules for individual debtors.

In a Chapter 11 case, a debtor's good faith can be established in his willingness to contribute substantial, new value to the reorganization effort. Absent this willingness, the creditors have no claim to this new value. By willingly committing new value to the company, however, the debtor establishes his willingness to increase his risk and to protect creditors insofar as he can. Nimmer, *Negotiated Reorganization Plans, supra.* In cases such as this, the law can ask for no more.

### 3. Failure to Recognize an Individual's Contribution of Essential Labor and Management Skills as New Value Gives Creditors an Unfettered Veto over any Plan of Reorganization.

In most Chapter 11 reorganizations, the outcome of the case is determined through bargaining among the parties, including secured and unsecured creditors as well as the debtors. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 224 (1977); Nimmer, *Negotiated Reorganization Plans, supra;* Booth, *The Cram Down on Secured Creditors: An Impetus Toward Settlement*, 60 Am. *Bankr. L.J.*, 69 (1986); Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651 (1974). The Bankruptcy Code affects this negotiation by providing each of the parties leverage to advocate their position. Confirmation rules in Chapter 11 affect this leverage and must be interpreted in light of their effect on the negotiation that is the heart of the reorganization process.



An absolute priority rule stripped of the new value rule would disenfranchise individual debtors whenever a class of unsecured creditors dissents and the current economics of the business does not support full repayment of all debts. Such a circumstance would leave the creditors entirely dominant whether the economic shortfall occurs because of general economic conditions, mismanagement or any other cause. Stripping the debtor of the right to obtain ownership of the reorganized debtor by a new contribution approved by a court weakens the individual's leverage, increasing the likelihood that he will suffer the full economic loss. It likewise increases the likelihood that such businesses will be liquidated, since the ability to reorganize the business under Chapter 11 will be meaningless. We doubt that Congress intended the provisions of Chapter 11 to be given an interpretation which destroys its central purpose.

Other chapters of the Bankruptcy Code applicable to some small business debtors do not adopt this policy. Chapters 12 and 13 permit individuals to retain ownership of their property under a "best efforts" standard if the creditors receive at least as much as they would receive in a liquidation and the debtor devotes a best effort to repay by committing his disposable income to the creditors. 11 U.S.C. §§ 1225, 1325. This entitles creditors to what amounts to the maximum recovery feasible from the debtor, but gives the debtor an option to retain non-exempt property by undertaking the effort. The debtor has this right. The creditors need not acquiesce.

Many small or individually owned farms and businesses, however, do not qualify for proceeding under either Chapter 12 or Chapter 13. For these businesses, their only

alternatives are in Chapter 7 liquidation or Chapter 11 reorganization. Unless a new value contribution reflecting an effort to protect individual debtors is permitted as of right, the consequence is that most such debtors will be unprotected. It is difficult to justify limiting the best effort standard based merely on debt size (Chapter 13) or type of business (Chapter 12). A best effort standard encourages and rewards efforts by an individual to treat his creditors fairly. This enhances a valid public policy that debts should be paid and that the person who makes an effort to do should be treated better than one who does not. *See*, Nimmer, *Negotiated Reorganization Plans*, *supra*. More importantly, however, such a standard makes meaningful the relief contemplated by Congress when it enacted Chapter 11.

## CONCLUSION

For all of the foregoing reasons, the decision of the Court of Appeals should be affirmed.

Respectfully submitted,

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